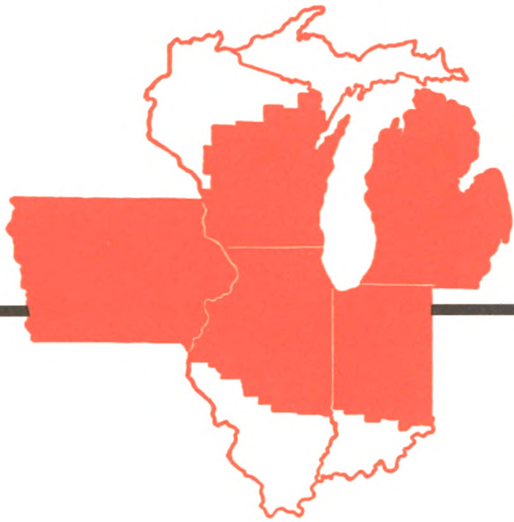
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1970 February

Contents

THE Trend OF BUSINESS

The business expansion that began in the spring of 1967 halted in the closing months of last year. A convincing body of evidence supporting this conclusion became available early in 1970. Total activity apparently leveled in the fourth quarter, and some sectors declined—both in the nation and in the Midwest. Sales and output of passenger cars and other consumer durables declined significantly. As yet unresolved is the question of whether the economy has entered a period of cyclical decline, the first since 1960.

Total employment increased only slightly in the fourth quarter, and manufacturing employment declined. Overtime hours were reduced or eliminated at many factories, and some short weeks were scheduled. Industrial production declined 2 percent from July to December, and new orders for durable goods receded from the record level reached in September. Many federal spending programs, especially on defense, were curtailed. Construction activity, led by homebuilding, was declining more than seasonally late in the year. Total spending on goods and services (the gross national product) rose at a much slower pace in the fourth quarter, and this rise merely reflected price increases.

The leveling in activity in late 1969 primarily was the result of a series of restrictive monetary and fiscal actions starting almost a year and a half earlier. But strikes played supporting roles. Most important was a work stoppage beginning October 27, and lasting through January, that involved more than 100,000 employees of the nation's largest producer of electrical goods. Upward stimulus will result as these disputes are settled and the pipelines restocked. But losses in income and profits associated with long strikes are not quickly recovered when production is resumed, especially in a period of slackened activity. Moreover, other far reaching walkouts, notably in motor transport, may lie ahead.

Recession ahead?

A period of slackened general economic growth with declines in construction and manufacturing does not automatically qualify for the recession label. A consensus definition characterizes a recession as a decline in total spending, adjusted for price changes, that extends for at least two consecutive quarters. The definition sets no standards for the amount of the decline in activity or the time required for recovery of previous peak levels after growth resumes. But it clearly excludes temporary pauses in activity such as occurred in 1962 and 1967.

The four "fully accredited" recessions of the postwar period began in 1949, 1953, 1957, and 1960, respectively. Succeeding declines in real gross national product from peak to trough quarters were not large, ranging from 1.4 percent (1960-61) to 3.9 percent (1957-58). The worst of these recessions was short and shallow compared to business downtrends recorded before World War II. Declines in industrial production were greater than declines in total activity, however, ranging from 8 percent to almost 13 percent, and even larger declines were recorded for the durable goods industries. In the cyclical troughs of 1958 and 1961, unemployment, always a lagging indicator, exceeded 7 percent of the labor force. The unemployment rate averaged only 3.5 percent in 1969, the lowest rate since the Korean War.

1969 vs. 1966

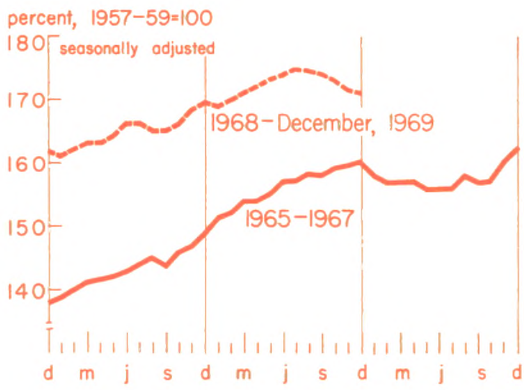
Comparisons of postwar pauses or recessions, although interesting and useful, do not provide sure clues to future developments. Examination of these periods reveals many similarities, but also striking differences.

Vast changes in the structure of the labor market, in the financial system, and in political philosophy, have altered relationships among economic developments from those existing ten or 20 years ago. The temptation currently, therefore, is to find parallels with the more recent developments of the 1966-67 experience.

Housing starts declined sharply from a seasonally adjusted high early in the year in both 1966 and 1969. Industrial production continued to climb throughout 1966, whereas a peak was reached in July 1969. Auto sales and production started down in the second quarter of 1966. A similar development did not occur until the fourth quarter of 1969.

Employment continued to rise at a good pace throughout 1966, in contrast to the leveling trend in late 1969. The unemployment rate remained relatively low in both years. Despite less vigor in employment and output trends, the unemployment rate was even lower in late 1969 than three years earlier. Insured unemployment, reflecting the status of experienced workers, was at the same low rate in both periods. New claims for unemployment compensation have increased significantly since November. A similar development occurred in late 1966.

Industrial production declined gradually from July through December



Sales and inventories

Recent trends in business inventories provide a marked contrast with the situation three years ago. Inventories rose $15 billion, about 12 percent in 1966, and the rate of rise jumped to a record $20 billion in the fourth quarter, as consumer purchases failed to match expectations. The ratio of inventories to sales rose substantially during the year.

Inventories rose only $8 billion, about 5 percent, in 1969. No appreciable increase in sales-inventory ratios occurred last year. The reasons are several. The normal tendency to keep inventories at the lowest level commensurate with efficient operations has been reinforced by closely limited credit availability and the highest interest rates in modern times. Apprehension of a general business letdown was present through most of the past year, a concern not evident until 1966 was well advanced. Manufacturers began to cut output in 1969 when sales prospects appeared unfavorable. Strikes, especially in the motor vehicle and electrical goods industries, that reduced output below desired levels in some cases, also were factors reducing growth in inventories last year. Finally, in contrast to 1966, retail sales did not slow in the fourth quarter of 1969 from the rate of earlier months. Sales of nondurables, in fact, showed relatively favorable gains in comparison with increases in disposable personal income, while sales of durables were lower than a year earlier.

Capital expenditures strong

Although most general measures of activity showed the business adjustment to be further advanced at the beginning of 1970 than three years earlier, various evidence indicates that capital expenditure prospects currently are appreciably stronger than in early 1967. Surveys of business investment plans indicate an increase of more than 10 percent in plant and equipment expenditures in 1970 from 1969. At the start of 1967, a rise of about 5 percent was anticipated (trimmed to an actual increase of about 2 percent).

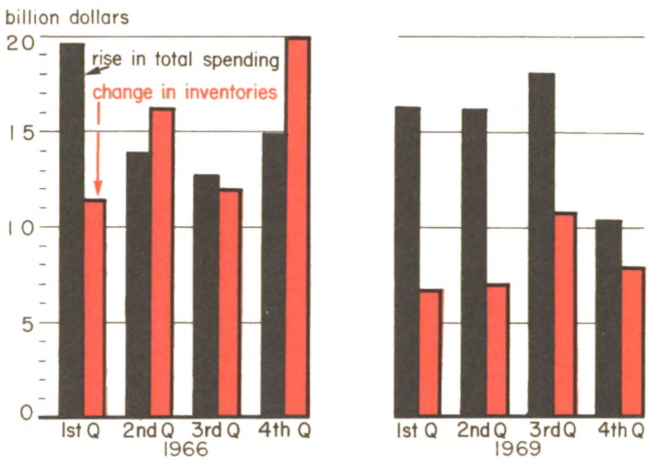
Capital spending appropriations approved by directors of large manufacturing companies, as tabulated by the National Industrial Conference Board, reached a peak in the second quarter of 1966, and then declined sharply. In 1969, these appropriations rose substantially in the third quarter, the latest for which data are available.

Allowing for strike influences, orders for most types of machinery and equipment were well maintained in the final months of 1969. Declining machine tool orders in the fourth quarter were in opposition to the general trend. The picture is especially strong for utilities—gas, electric, and communications. But demand from manufacturers and other industries for many types of equipment—including air conditioning, trucks, railroad equipment, electrical apparatus, chemical processing facilities, and office equipment—remains vigorous. Construction contracts for commercial buildings have been very large.

The sharp dichotomy of weak demand for consumer durables and strong demand for producers durables is unique in the postwar period. It reflects the confidence of business in prospects for an early resumption of growth, continued expectations of price inflation, and the desire to reduce labor costs, in addition to needs for more capacity and higher quality products.

In time, a more normal relationship among developments in these broad industry groups will

Inventory growth in 1969 below 1966 rate



be re-established. Lower profits and lower than expected sales might cause some companies to scale down capital expenditure plans. But past patterns suggest this will happen on a broad scale only if a recession develops. An alternative possibility is a resurgence in consumer purchases of durables from recently depressed levels. This could occur if individuals' spending and use of credit resumed a more normal relationship to income.

The course of policy

Contrasts in monetary and fiscal policy actions in 1969 and 1966 are at least as marked as differences in business developments. Fiscal policy played no positive role in repressing the boom in 1966. Federal expenditures continued to rise rapidly, while tax rates remained unchanged. Last year, expenditures increased but less rapidly, while receipts rose, partly because of the higher tax rates enacted in 1968.

Monetary policy was relatively restrictive throughout 1966. Credit markets tightened severely for a brief period in August. The resulting scramble for funds was soon tagged as a "credit crunch," to describe the fear in some financial circles (albeit unfounded) that a liquidity squeeze of panic proportions was developing.

The growth of credit, especially total bank credit, was checked early in 1969. But at no time did circumstances resemble those prevailing during the crunch. Instead, commercial banks, as well as most other lenders and borrowers, developed new sources of funds to moderate the impact of restrictive credit policies.

The next phase

Seldom before have the monetary and fiscal authorities worked in such strong concert to contain a rapid and long continued wave of price inflation. Actions intended to slow the rise in spending have been successful. The rate of price increase, if not reduced, probably is no longer accelerating. Hopefully, the coming months will bring a moderation in the uptrend.

Monetary policy, largely unaided, halted the rise in spending in late 1966 and early 1967. Price inflation slowed substantially in the first half of 1967. The momentum of the inflation is much greater now than three years ago. But margins of unused capacity are now building in manufacturing facilities and in the labor force. Businesses and governments continue their efforts to hold down inventory accumulations and new hirings. Consumers remain cautious. Taken together, these developments comprise the anti-inflation forces that work to contain inflation in a free society.

The EEC and U. S. agriculture

Twelve years have passed since six European nations banded together to promote trade among themselves. In 1958, Belgium, France, Italy, Luxemburg, Netherlands, and West Germany created the European Economic Community (EEC), often called the Common Market. One objective of the organization was the gradual elimination of tariff barriers among the members and the establishment of common tariffs for trade with other nations.

Early last December, after 12 years of operation, the member nations met to discuss the future of the organization. Discussions and negotiations still in progress are concerned with possible expansion of the membership, problems of economic and political integration, and possible changes in the group's common agricultural policy (CAP). Because the EEC is a major importer of United States agricultural products, the outcome of these negotiations will be of special interest to American farmers.

Farm problems in Europe

Agricultural policy formulation has been one of the most difficult tasks encountered by the Common Market since its founding. Indications are that it will be no less vexing in the future.

High price supports have promoted increased agricultural output within the group, and burdensome surpluses of some products have accumulated. If agricultural prices within the Common Market are maintained at the present high levels, potential new members with lower agricultural prices would experience some problems in negotiations for membership in the EEC. British consumers, for example, would not welcome the high food prices of the Common Market, nor would the British government willingly accept the high costs incurred by the EEC in maintaining support prices and export subsidies.

Prices and production in the Common Market are protected by various restrictions on imports, and some exports are promoted by export subsidies. Import restrictions on food, feed grains, and livestock have limited shipments from the United States, Canada, Argentina, and Australia. Furthermore, exports of many less developed countries have been held down by preferential trade agreements of the EEC with former French colonies in Africa. South American exports have been especially hard hit by these agreements.

A major U. S. market

The Common Market is the largest export market for U. S. agricultural commodities under a single jurisdiction, accounting for 22 percent of the total in 1968. That year, 15 percent went to Japan, and 10 percent each to Canada and to the countries associated

NOTE: Major sources for this article include:

Berntson, B. L., et al., **The European Community's Common Agricultural Policy—Implications for U. S. Trade,** U. S. Department of Agriculture, October 1969.

Sorenson, Vernon L., and Hathaway, Dale E., **The Grain-Livestock Economy and Trade Patterns of the European Economic Community,** Michigan State University, 1968.

in the European Free Trade Association (EFTA).[1] Feed grains and oilseeds and oilseed products (primarily soybeans) are the most important EEC imports from the United States, accounting for three-fifths of the total.

Soybeans and corn, major U. S. agricultural exports to Common Market

	1960		1968		Percent change
	Amount	Percent	Amount	Percent	1960-68
	(million	dollars)			
Soybeans and soybean products	139	13	440	32	+217
Corn	83	8	313	23	+276
Wheat and flour	54	5	84	6	+ 57
Oilseeds and oilseed products other than soybeans	59	5	49	4	− 17
Feed grains other than corn	114	10	23	2	− 80
All other	650	59	458	33	− 44
Total	1,099	100	1,367	100	+ 24

Changes in the common agricultural policy arising from negotiations among the EEC members and prospective new members could be of considerable significance to American farmers. At present, the common agricultural policy is highly protectionist. Any substantial easing in the restrictions on imports would benefit the United States and other exporters of agricultural products. A less restrictive posture would also facilitate British entry into the Common Market. Conversely, if Britain were to adopt a more restrictive posture toward agricultural imports in order to join the EEC, both American farmers and British consumers would be affected adversely.

Origins of the policy

The first steps toward establishing the common agricultural policy were taken in 1962. A common level of agricultural prices was to be achieved by the end of 1969, a goal realized in July 1968.

Common Market agricultural policies are administered through a complex framework of interrelated regulations, which vary among commodities. Basic features include:

(1) "Target" or internal support prices set by the EEC yearly;

(2) "Variable levies" on certain imported agricultural products equal to the difference between the world price of the commodity and the "threshold" price, the lowest price at which particular imported commodities may enter the market (Support prices and threshold prices are virtually identical.);

(3) Export subsidies enabling certain EEC commodities to compete on the world market;

(4) A European Guidance and Guarantee Fund financed by import levies and member assessments that supports both internal EEC "target" prices and the EEC export subsidies.

The CAP programs for high level price supports, the levies on selected imports, and the export subsidies are of particular concern to U. S. agriculture. The levy fluctuates with the world prices for the products. Among commodities subject to the variable levy are feed and food grains, beef and veal, pork, food lard, dairy products, and poultry products. Commodities subject to the variable levy accounted for 27 percent of U. S. agricultural exports to the EEC in 1960 and 37 percent in 1968.

Prior to the EEC, member countries did

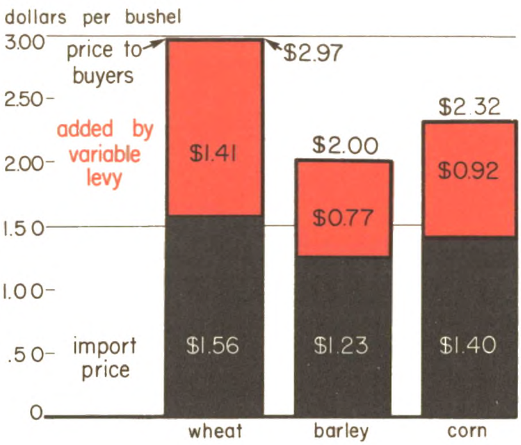
[1]The eight EFTA countries are: Austria, Denmark, Finland, Norway, Portugal, Sweden, Switzerland, and the United Kingdom. Iceland has been accepted for membership and will officially become a part of EFTA during 1970. EFTA members have eliminated tariffs among themselves, but the organization does not impose common restrictions against nonmembers.

not produce enough feed grains, high protein wheat, meats, and poultry to meet domestic needs. Higher production stimulated by CAP programs has reduced the deficit in some commodities, but member nations still import large quantities of feed grains and lesser amounts of hard red wheat, durum wheat, and meats.

Substantial surpluses of some commodities have accumulated within the EEC. Export subsidies—principally for grains, dairy products, sugar, meat, and poultry—have been used extensively in order to move these supplies into world markets.

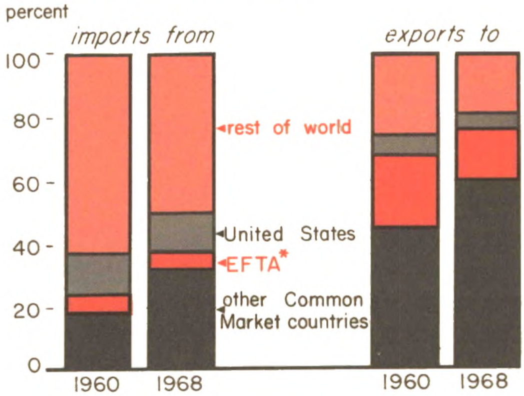
Sizable surpluses of dairy products have accumulated in the Common Market in recent years. Most European cattle are dual purpose, beef-milk breeds. Improved feeding has been emphasized to increase beef and veal output. But existing price support levels do not adequately encourage meat production over milk production. The result has been a

Common Market levies substantially raise prices of imported grains



SOURCE: U. S. Department of Agriculture.
Data are an average for year ended July 1968.

Larger share of agricultural trade in Common Market is among members



*European Free Trade Association.
SOURCE: U. S. Department of Agriculture.

chronic surplus of milk and milk products. In the fiscal year ended June 30, 1969, the EEC spent more than $600 million for dairy price supports and export subsidies alone.

All expenditures on price supports and subsidies under CAP programs cost $2.4 billion in fiscal 1969—a sixfold increase from 1963 and a third more than in 1968. Expenditures have been projected as high as $3.4 billion yearly by 1975.

If the agricultural budgets of the six nations are added to the costs of the Guidance and Guarantee Fund, it has been estimated that total agricultural policy costs in the Common Market countries exceeded $8 billion in the year ended in June 1969. The U. S. agricultural budget cost about $6 billion in the same period.

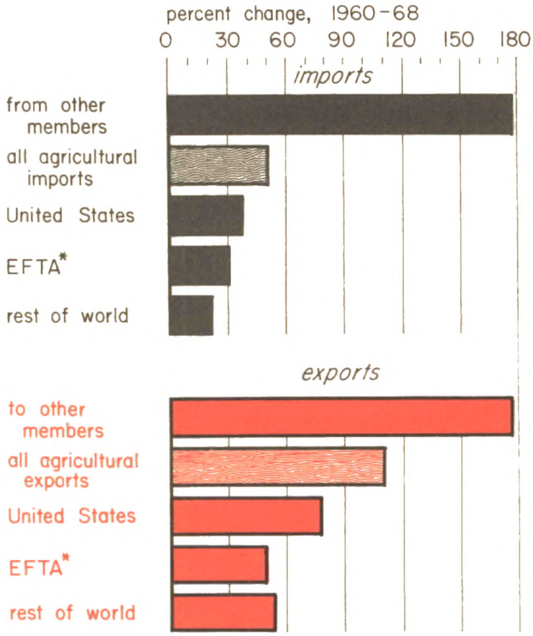
U. S. share declines

The United States has been an important supplier of agricultural products to Common Market countries for many years. Trade patterns, however, have changed since the establishment of the EEC in 1958. A principal reason for the removal of trade barriers within the Common Market was to increase trade among the members and reduce their trade with nonmembers. These intentions have been realized to a marked degree.

From 1960 to 1968, agricultural trade within the EEC nearly tripled, while imports from both the United States and the EFTA countries increased by only about one-third, and trade with the rest of the world increased only one-fifth. Exports from the Common Market to nonmembers during this period grew much faster than imports—77 percent to the United States and 48 percent to EFTA countries.

Changes in market shares also reflect the shift in trade patterns. From 1960 to 1968, the share of total imports from other members within the Common Market rose from 18 percent to 32 percent, while imports from the United States declined slightly. The pattern for exports was similar. Intra-EEC exports expanded from 45 percent to 60 percent, while the share of exports to the United States and EFTA declined.

Growth in agricultural trade of Common Market largest among members



*European Free Trade Association.
SOURCE: U. S. Department of Agriculture.

Changes in composition

A substantial shift in the composition of U. S. agricultural exports to the EEC has occurred since 1960. Although feed grains are subject to high internal EEC price supports and imports are subject to the variable levy, U. S. corn exports to EEC nations nearly quadrupled between 1960 and 1968. The gain reflects the EEC's increasing need for foreign feed grains to promote meat production.

United States exports of beef, veal, and other meat products to the EEC have risen rapidly since 1960 because of the EEC's continued difficulty in increasing beef and veal output. The upward trend in U. S. beef exports to the EEC will probably continue. It should also be noted, however, that the Europeans prefer leaner meat to the high degree of marbling favored and produced in the United States.

Much of the increased importation of feed grains in Europe is fed to poultry and swine. EEC policies have effectively closed the Common Market to U. S. poultry exports. High threshold prices for imports and the variable levy provide protection for European producers. The EEC also subsidizes poultry exports, thereby cutting into U. S. sales to non-EEC European countries. In 1968, the United States retaliated by providing an export subsidy on poultry to match EEC subsidized export prices.

The most important category of U. S. agricultural exports to the EEC is the oilseed and oilseed products group, mainly soybeans from the Midwest. But this is a relatively new development. As recently as 1960, oilseeds and oilseed products made up 18 percent of the value of U. S. agricultural exports to the EEC—tied with feed grains behind raw cotton. By 1968, oilseeds and oilseed products accounted for 36 percent of the total, far ahead of second-place feed grains. Soybeans and soybean products—important in European diets, but not grown there in quantity—are exempt from the variable import levy. A tax on oilseeds and oilseed products, internally produced as well as imported, is now under consideration. The purpose is to raise the price of margarine, thereby encouraging consumers to eat surplus butter.

A tax is also proposed on oilcake which is fed to cattle as a protein supplement. Higher resulting feed costs would reduce oilcake utilization and imports and reduce milk production and surpluses, but would also reduce meat supplies—a result not desired. Furthermore, consumption of high protein feed grains could be substituted for oilcake, defeating the purpose of the tax. United States policy vigorously opposes this tax proposal, and retaliatory measures aimed, perhaps, at EEC industrial products are a possibility.

Future developments

Expansion of the Common Market membership is possible in the next few years. The most likely candidates for inclusion are Denmark, Ireland, Norway, and the United Kingdom. The conditions of their entry will be of particular interest to U. S. agriculture. Britain, which in 1968 took 6 percent of U. S. agricultural exports, imports foods at prices well below those prevailing in the EEC. Although some adjustments in the EEC's agricultural policy would be required before Britain would join, it is probable, nevertheless, that British membership in the EEC will result in further restrictions on imports of U. S. agricultural products.

In large part, increases in agricultural exports to the EEC since 1960 were in soybeans, which do not face significant restrictions. But feed grain exports to the EEC, especially corn, also grew substantially, in spite of heavy import restrictions. This growth is attributed to the feed grain deficit of the EEC associated with emphasis on increased meat and poultry production. In part, increased U. S. feed grain exports replaced poultry exports to the EEC, which have almost ceased.

The future of U. S. agricultural exports to the EEC is uncertain at this time. Since 1966, these exports have declined. Shipments of products that are subject to the EEC's variable levy have dropped much more than those not under the levy. Exports of soybeans and soybean products continued to increase after 1966—though at a much slower rate than during the early 1960s.

Principal uncertainties concerning restructuring of the EEC common agricultural policy may be resolved within the next 18 to 24 months. Changes may involve expansion of membership and measures to halt the rapid rise in agricultural outlays.

Agricultural policies, both within the existing Common Market and in potential member nations, are influenced by strong and volatile political forces. Policies that would substantially lower farm prices will meet determined opposition. Leaders in these nations will be exploring plans to lower internal agricultural program costs, dispose of surpluses, and expand production of certain products. Little hope exists that the Common Market will soon relax its protectionist policies.

Farm mortgages—

The impact of tight credit

Total farm debt more than doubled in the 1960s. The increase was divided about equally between loans secured by farm real estate and other farm credit. Farm mortgage debt, now totaling about $29 billion, has increased about $2 billion annually since 1965.

About two-fifths of farm mortgage debt outstanding is held by individuals. Federal Land Banks and life insurance companies each have a fifth of the total and commercial banks have about 15 percent. These four groups of investors hold more than 95 percent of farm mortgage debt. The remainder is held by the Farmers' Home Administration, savings and loan associations, mutual savings banks, and other lenders.

The relative importance of the major groups investing in farm mortgages changed substantially in the 1960s, and the shift has accelerated in the past two years of tight money and sharply higher interest rates. Most notably, individuals and the Federal Land Banks have increased their participation in new farm mortgage loans in recent years, while the role played by life insurance companies has diminished.

Individuals lend more

By far the largest share of farm mortgage debt has always been held by individuals. In most cases, these loans result from sales of farms rather than through investment of cash. Last year, individual lenders probably acquired more than half of the increase in farm mortgage debt—up from 40 percent as recently as 1965. Individuals now grant almost twice as much new farm mortgage credit as the next largest class of lenders, and the margin is widening.

The growth of the individual sector in farm mortgage finance in recent years is partly a result of the attractive alternative investments available to institutional lenders. But it also reflects the desire of many farmers contemplating retirement to retain an investment interest in their former properties or in other farm real estate, rather than experiment with less familiar alternatives.

More than half of farmland sales are seller-financed and, of these, about 80 percent are sold under land contracts. The land contract is a flexible instrument adaptable to individual circumstances. Because the sale is conditional, title typically does not pass until the contract is fulfilled. Repossession of the property, therefore, is facilitated in case of default.

The use of land contracts has been growing in recent years for a number of reasons. Lower downpayments may permit sales at higher prices to a larger number of buyers, often friends or relatives. Another advantage to sellers is that, providing downpayments are less than 30 percent, capital gains income may be spread over several years and tax liabilities reduced. When sellers of farmland have large equities, frequently the case in recent years, seller-financing under land contracts may be preferred, even when other sources of credit are available. Existing owners often are willing to grant credit on more favorable terms with interest rates as much as a half percentage point lower than rates charged by institutional lenders.

All of these factors are still present. Sellers of farms therefore may assume a still larger role in financing these properties in the years ahead.

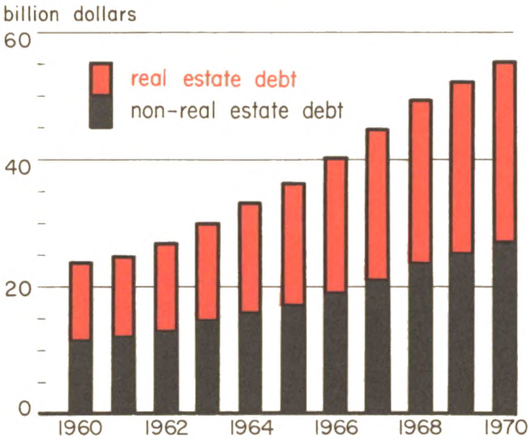
Land Banks expand loans

Federal Land Banks have financed more than a fourth of the increase in farm mortgage debt in recent years. In 1964, these banks accounted for a fifth of the rise in farm mortgages.

Lending activity of the 12 Federal Land Banks is restricted to farm real estate. They raise funds through sales of bonds on the open market at relatively favorable rates. The Federal Land Banks are farmer-owned cooperatives and pay smaller income taxes than other corporations. Also, their loans are exempt from state usury statutes, an important factor in the past year or two. Thus, the Federal Land Banks have an advantage over other institutional lenders in their field of specialty. All of these factors have helped them to play a larger part in the farm real estate credit picture in recent years.

The Administration in late 1966 requested various federal agencies, including the Federal Land Banks, to restrict new securities issues to refundings of maturing obligations. This resulted in reduced commitments to make new farm loans in 1967 and may have been responsible for slower growth in lending in 1968. The restrictive lending policy was then relaxed, however, and a resurgence in mortgage loans by the Federal Land Banks occurred in 1969. This trend appears to be continuing in 1970.

Farm debt more than doubled in the Sixties*



*Amount outstanding in 48 states, January 1. Excludes commodity credit corporation loans.

Insurance companies cut back

The proportion of new farm mortgage debt taken by life insurance companies has declined each year since 1964, when they accounted for almost a fourth of the rise in outstandings. By 1968, the life insurance company share of new farm mortgages was down to 10 percent, and last year, the proportion was only about 5 percent.

Life insurance companies can purchase a variety of debt and equity investments. They have wide latitude to shift available funds to the highest earning assets. In 1969, high-grade corporate bonds were sold to yield as much as 9 percent annually. Even higher rates were available on commercial and industrial mortgages. In addition, many bond issues and loans have had a claim against equity in some form—"a piece of the action." Not only are such provisions seldom included in farm or home mortgages but, in addition, farm loans typically are subject to usury ceilings. Another factor causing life insurance companies to reduce new long-term investments of all classes has been the sharp increase in their policy loans starting in 1966.

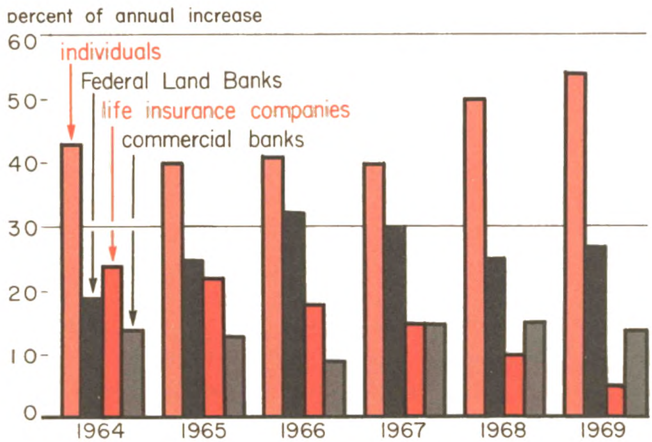
Impact in the Cornbelt

The decline in farm mortgage lending by insurance companies has probably been felt most strongly in the Cornbelt, which includes the Seventh District states of Illinois, Iowa, and Indiana, where these companies have traditionally been more important as suppliers of farm real estate credit than in other regions. A review of farm mortgages recorded by life insurance companies through 1968 reveals a sharp downtrend in each of these states.

Recordings by insurance companies in both Illinois and Iowa reached peak dollar levels in 1965. Three years later recordings had declined by almost a half in Illinois and by a third in Iowa. In this period, the proportion of all farm mortgage recordings accounted for by life insurance companies dropped from a third to a fifth. In Indiana, insurance companies' share of farm mortgage recordings averaged close to a fifth of all recordings in 1965, but in 1968, only a tenth.

Insurance companies' farm mortgage lending historically has been comparatively small in Wisconsin and Michigan. Even so, as in the other district states, their role has declined. Farm mortgage recordings by insurance companies in Wisconsin were 10 percent of the total in 1965, and in 1968, only 4 percent. In Michigan, the decline was from 5 percent to 2 percent. As in the rest of the nation, the decline in farm real estate lending by insurance companies has been about offset by increases for individuals and Federal Land Banks.

Individuals' share of farm mortgage loans rises as insurance companies' share declines



SOURCE: Flow of Funds, Federal Reserve Board.

Banks' role stable

Throughout most of the 1964-69 period the proportion of the annual increase in farm mortgage debt held by commercial banks remained at about 15 percent. Farm real estate lending by rural commercial banks is influenced more by trends in deposits locally than by conditions in the national credit markets. Despite attractive yields on money market investments, most country bankers look to their market areas for long-term growth in both deposits and in loans.

In most farm communities, a few large bank depositors have shifted their funds to other investments in response to the higher rates available. But this development appears to have had only a small influence on the growth of deposits at most rural banks.

Farm real estate mortgages are not the primary credit extended by commercial banks. Normally, banks prefer to accommodate short- and intermediate-term credit demands before committing funds to long-term loans. Therefore, their holdings of farm mortgage loans usually depend on the local credit situation. Nationally, farm real estate loans are about 15 percent of all bank loans to farmers, but in the Seventh District, the ratio exceeds 17 percent. Some of these loans are temporary accommodations, pending the arrangement of long-term permanent financing with another lender. Some are mortgage loans because farm real estate was taken as collateral on loans extended for other purposes and did not arise out of a land transfer.

Commercial banks are unlikely to increase, and may reduce, the rate of growth of their farm real estate loans. In recent years, bank loans have been increasing much faster than deposits. From 1961 to 1968, total deposits of "agricultural banks" in the Seventh Federal Reserve District—banks at which farm loans are at least 30 percent of the loan portfolio—increased about 52 percent. Farm loans at these banks increased 70 percent in the same period. One result, of course, has been a rise in loan-to-deposit ratios.

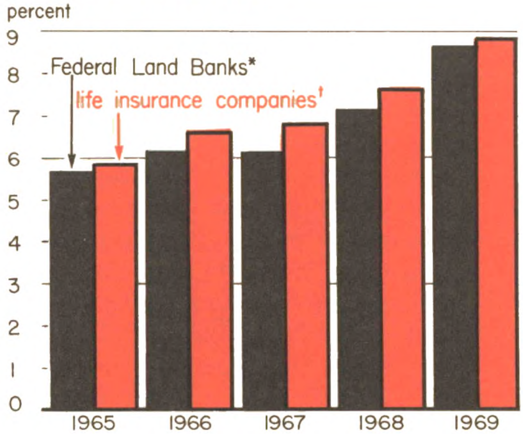
Fewer than half of the agricultural banks in the Seventh District had loan-to-deposit ratios of 50 percent or more at mid-1961. But, by mid-1968, about two-thirds reported ratios of at least 50 percent. As loan ratios have increased, some bankers have become more cautious on new commitments, especially for long-term real estate loans.

Future trends

A somewhat slower increase in farm real estate debt is probable in the 1970s. The increase in farm mortgages in the 1960s was associated with a strong uptrend in land prices, a rise in the percentage of farmland transfers that were credit-financed, and a rise in the ratio of mortgage debt to purchase price. Each of these factors may be less significant in the future.

Farmland prices rose faster than the general price level during the 1960s, reflecting

Farm mortgage interest rates rise



*Rates charged by majority of associations effective third quarter each year.

†Average rate charged by major life insurance companies on new loans September 30.

the impact of government programs, labor saving technology, improved crop yields, the drive toward farm enlargement, and the encroachment of urban developments on rural areas. Early in 1969, farmland values were 60 percent higher than in 1960. By comparison, a measure of all prices of goods and services (the gross national product "deflator") rose 22 percent in the same period. The softening in farmland prices in the past year suggests this relationship has changed, but this may be partly a reflection of reduced credit availability and high interest rates. It remains to be seen whether any future advance in land prices will be more in line with changes in agricultural commodity prices and the general price level.

Credit-financed sales of farmland rose from 67 percent of all sales in 1960 to 80 percent in 1969. It is unlikely that the proportion of credit-financed sales will continue to rise significantly, because some transfers will always be for cash. Similarly, the rise in the ratio of debt to purchase price on credit sales of farmland from 65 percent in 1960 to 74 percent in 1969 leaves less margin for a further increase. Also, unless interest rates decline significantly, refinancings will be less common, and refinancings have helped to push debt ratios to present levels.

When credit demands are strong relative to the supply, credit tends to flow to those borrowers willing and able to pay the higher interest rates. It appears that purchasers of farm real estate are more sensitive to strongly rising interest rates than most other borrowers and, therefore, compete less vigorously for borrowed funds when rates are high. In some cases, demand has been limited by legal interest rate ceilings.

Easing of usury ceilings that prevent lenders from charging market rates of interest to individuals would facilitate some farm transfers through broadening the market for farm debt. Three states of the Seventh District—Illinois, Iowa, and Michigan—had usury ceilings on real estate loans to individuals of 7 percent through part of 1969. In April 1969, the Iowa ceiling was raised to 9 percent, and in July, the Illinois ceiling was raised to 8 percent. Even so, these new higher ceilings continue to restrict credit availability. The statute was suspended for one year in mid-1969 in Michigan for home mortgages and land contracts but, apparently, not for farm real estate loans.

The virtual withdrawal of life insurance companies from farm real estate finance may be only temporary, as in the past. Farm loans of these companies declined in the late 1950s, but rose again when credit conditions eased in the early 1960s. However, the trend of interest rates has been generally upward since World War II, and there is no clear evidence that interest rate levels will decline substantially in the years ahead.

In summary, farm real estate debt will probably rise substantially further in the 1970s, but at a slower rate than in the 1960s. The shifts that have occurred among farm mortgage lenders in recent years are likely to continue. Shares of farm mortgages held by individuals and the Federal Land Banks will probably rise still further, while life insurance companies are likely to continue to de-emphasize these investments.

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