Meeting the future credit needs of

Despite the increasing urbanization of society, agriculture remains one of the biggest and most important single industries in the United States. Its problems deserve the concern of all citizens.

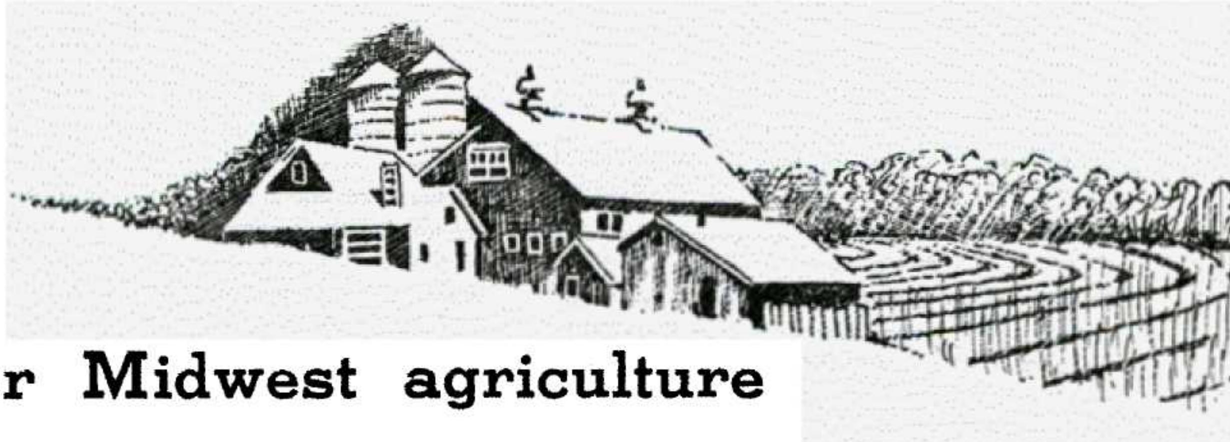
American farms provide three times as many jobs to the economy as any other industry, and generate more investment in capital equipment than any other industry. Farms are a mainstay of the economy and particularly to thousands of smaller communities across the country.

In meeting the credit needs of so important an industry, bankers have a vital job to perform, a job made even bigger and more complex by recent changes which 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 or approximately 50 per cent during the last five years, and banks throughout the country have contributed a significant portion of this credit. They have maintained a competitive position with approximately 13 per cent of farm mortgage loans, while on other loans, they have lost ground somewhat — dropping from about 67 per cent in 1960 to about 64 per cent by 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. But there is another important problem for bankers — that problem is to make sure that they are applying their necessarily limited loan resources to meet real, constructive credit *needs* and not to dissipate what they have in meeting credit "demands" that benefit neither their customer nor themselves. This is a problem which involves 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.

Agriculture's pattern different

When an industry's need for credit increases greatly within a short period of time and gives every indication of continuing to do so for some time to come, one is usually 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 this product is outrunning production, and that credit financed expansion of productive facilities is therefore essential. But, unfortunately, this is not the case for agriculture. In the Ninth district, for example, farm gross receipts and net income, while fluctuating widely, have shown no upward



Upper Midwest agriculture

trend in recent years, and the number of farm jobs has decreased. 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 this has been happening, 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. Also, farm employment has decreased to an annual average of 6.5 million in 1963, a drop of 13 per cent from the 1957-1959 average.

Agriculture, therefore, appears to be an industry that in the aggregate is using credit for modernization rather than for expansion. True, some farmers are using more credit to obtain control over a larger volume of productive resources, but even these moves to larger enterprises can be regarded as modernization since smaller and usually less efficient units are eliminated. Other farmers are using more credit to enable them to buy equipment or adopt production techniques that will lower their costs.

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, the process has made food costs lower in terms of man-hours of labor than ever before; but, on the other hand, the continuing growth in size and reduction in number of farms has caused many rural communities to come to a standstill or to decline both in population and gross income. This latter development is 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.

Other changes lead to problems

Off-farm changes in agriculture have further aggravated the financial problems of rural communities. A tremendous increase in the purchase of production supplies of nonfarm origin 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

This article is based on remarks made by Charles N. Shepardson, member of the Board of Governors, Federal Reserve System, at the Upper Midwest Agricultural Credit Council at Bismarck, North Dakota, June 25, 1964.

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 jobs formerly done on the farm or by small local plants.

Modern transportation and communication methods have brought 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. It is a process of consolidation, and the communities and the business and financial enterprises that survive are those which gear their operations to provide the services needed, including the needs of larger farm enterprises.

Key role of the rural banker

The rural banker has a key role in the competition that is determining which communities survive and which communities fail. The effectiveness with which he meets the problem of obtaining new loanable funds, and the skill and courage he displays in using those funds most productively, will likely determine his own fate and will influence the fate of his community. His opportunities will never be lacking. Although farm population has fallen to a level of less than 8 per cent of the total as against approximately 25 per cent only 30 years ago, agriculture still is a $45 billion-a-year business. Moreover, when one considers the related supplier, processing, and distribution industries directly dependent on the farm sector, he finds that the total agricultural industry engaged in the job of providing food and clothing to the nation employs approximately 40 per cent of the labor force — certainly a major factor in the total economy.

There are many bankers who are apparently recognizing the opportunities, and the recent upward shift in loan-to-deposit ratios indicates that banks in the Upper Midwest are meeting farm credit demands at a faster pace than their own deposits are increasing. But a number of other bankers 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. Some bankers, in fact, 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. If, as a result of this thinking, 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.

What are the limits to credit expansion?

In view of the obvious essential of providing for the real credit needs of agriculture and considering both the national welfare and the well-being of farmers, are there any limits to the amount of credit that should be supplied? This is a difficult 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 on 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 all. And when one considers farming as a whole, he finds that there are limits on the rate at which changes can take place without backfiring.

To illustrate:

The review of Upper Midwest farming that was done as part of the excellent Upper Midwest Economic Study revealed that many farmers are under-employed 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? The result would probably be that another study would be needed in short order. Something like this, after all, has been happening in cattle feeding during the last few years. The 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 have not remained profitable when the rate of adjustment by all farmers taken together exceeded the rate of growth of the market. In fact, this, not Australian beef imports, is the real root of the present beef cattle price problem.

Limits in wheat credit flows

Wheat farming 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.

But, again, 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 rise, and the man who pays the higher price, even though he can average it 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, land price inflation creates a real problem for the new operator who must buy his entire unit at the higher price. As with cattle, too rapid a rate of expansion by farmers as a group may be self-defeating.

Examples:

During the five years ending in 1963, farm land prices in North Dakota have risen by 24 per cent. Total farm mortgage debt has just about doubled. In Montana and South Dakota. the rise in land prices has also been in the range of 20 to 25 per cent. Again, buyers have apparently used large amounts of credit to consummate the transactions. Outstanding farm mortgage debt in both states has risen by about 60 per cent during the five years.

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

The lender's dilemma

It's clear that an increasingly troublesome situation exists — one which involves many farm mortgage lenders in all types of lending institutions: banks, insurance companies, and Federal land banks. While these lenders 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 overcome their better judgment.

From an over-all viewpoint, whenever one talks about the optimum flow of mortgage credit needed to carry out the desirable adjustment to larger acreages, he must be aware of the limited supply of land on the market and of the possible consequences on land prices. Also, from a national viewpoint, when one talks about the optimum supply of credit to finance adjustments that will tend to increase output, he must keep in mind the limit on the ability of the market to absorb this increase without resulting in disastrous reductions in prices.

Sources of funds

As to sources of additional funds to keep up with the growing credit needs, one should start by observing the outlook for demand deposits. These deposits derive primarily from the gross income of the area. Since, as 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. Further, general increases in rates of interest in recent years have given people added incentive to place their savings in a place where it will earn interest, and to place temporarily inactive funds in an interest-bearing account rather than holding them as demand deposits. Thus, as people have 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 bank 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 a bank less 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, one 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 over 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 a while rural residents were at a disadvantage compared to city dwellers in this respect because nonbank savings institutions were not as numerous in country towns. This situation now has changed. Most farmers are quite mobile and make frequent visits to the larger trading centers. They are also exposed to save-by-mail advertisements.

The question, then, is: 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 increase from approximately $108.7 billion to $121.1 billion, a rise 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 per cent in three others, a large range and yet not conclusive since the figures do not reflect the level from which each started. Neither do these figures take into account 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 $3\frac{1}{2}$ 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, while realizing that this cannot be the entire or even a major portion of the answer.

Use of the correspondent system

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. That potential, to be realized, 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 must 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.

At the other end, the urban bank should go beyond the minimum of simply handling the participation requests. It should advise its correspondents of its interest in farm loans and specify the information that should 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, the city bank can take a still more active role in working directly with these potential customers.

It is an illusion for the city banker to think he has no interest in farm loans: he has had 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 the city banker must take an interest in the one in order to protect his interest in the other.

Other sources

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 special loans 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. 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.

Also, farm loan discount facilities provided by law for commercial banks at the Federal Intermediate Credit Banks deserve attention. It does not seem to be generally known that banks have access to the discount facilities of the Federal Intermediate Credit Banks through either agricultural credit corporations organized by the bank for that purpose or by directly discounting farm loan paper with that agency. In either of these ways, banks have access to funds obtained in the national credit market at the same discount rate (presently $4\frac{3}{4}$ 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 competitive factors may dictate a narrower margin. Any bank unable to meet a good farm loan request from its own funds or through its correspondent would do well to look to this source rather than lose the customer. Also, discounting of farm loans in this way would seem to be a potential source of funds for city correspondents who may wish to provide a farm service but who find themselves already overextended in terms of loans.

In addition to these sources, resources of the Federal Reserve bank are available to member banks to aid in adjusting portfolios to unexpected deposit withdrawals or other unusual needs.

Summary

In closing, there is nothing new or unusual here in the way of suggestions as to how banks can meet the credit needs of modern agriculture. There are no magic formulas. In the end, 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 individual and collective borrower.

Current conditions . . .

District business activity at mid-year seems to be gathering momentum, sparked by prospects of another good crop production season. Bank debits in June were up 18 per cent from a year earlier. Department store sales were up strongly in early July. Consumer credit has been expanding; and construction work, except residential building, has been moving ahead vigorously. Manufacturing employment in Minnesota was expected to improve during July. The industrial use of electric power expanded an estimated 8 index points from May to June. Shipments of iron ore from Lake Superior ports since the start of the season have been running about 23 per cent ahead of last year. Total district personal incomes at mid-year, based on a two- to three-year trend line, continue to roughly parallel that of the nation. District wheat production was estimated on July 1 by the Department of Agriculture to be 10 per cent above that of last year. Montana may have the largest crop since 1958 and on less acreage. South Dakota's 1964 wheat output was estimated about 30 per cent over that of last year.

Assuming normal rainfall and temperatures for corn, soybeans, and other late crops in July and August, agricultural output should about equal last year's favorable experience. Incomes, however, may not equal those of 1963. Farm product prices in the district have been trending a bit lower compared with last year, with cash farm incomes correspondingly lower.

Since the first of the year, bank deposits have trended downward at city banks, upward at country banks, with total deposits at all member banks standing about $55 million higher at the mid-year point. Loans at member banks have been expanding somewhat more rapidly than deposits: in June the loan-deposit ratios inched up to the record or near record levels of the 1920's. To meet the expanding loan demand, district member banks at mid-year continued, as they have since late March, to be net purchasers of federal funds and to continue borrowing from the Federal Reserve Bank of Minneapolis.

In summary, current business conditions and prospects appear favorable based on available statistical trends and agricultural output prospects in late July.

The following selected topics describe particular aspects of the district's current economic scene:

DISTRICT CREDIT

Aided by an accelerated rate of credit expansion during the second quarter, total loans and investments at district member banks rose by $141 million in the first six months of 1964. This surpasses the $112 million increase during the similar period in 1963 (see Table). The $186 million increase in the loan component during 1964 was not significantly different from the previous year's growth, but a $45 million reduction of investment holdings in 1964 was so much smaller than that for 1963 that it almost entirely explains the difference in total credit expansion.

CHANGES IN LOANS AND INVESTMENTS AT NINTH DISTRICT MEMBER BANKS FIRST SIX MONTHS OF THE YEAR

(Wednesday closing figures, millions of dollars)

	1964	1963
All Member Banks		
Total	$141	$112
Loans	186	184
Investments	— 45	— 72
City Banks		
Total	73	29
Loans*	63	59
Investments	10	— 30
Country Banks		
Total	68	83
Loans	123	125
Investments	— 55	— 42

*Exclusive of loans to other banks.

City banks reported a $73 million increase in total credit for the first six months of 1964 compared to the $29 million rise recorded in the first half of 1963. The higher growth rate in 1964 can be attributed substantially to the fact that city banks were able to add $10 million to their investment portfolios this year due to a greater source of funds; whereas in 1963, they were forced to liquidate $30 million in security holdings in order to finance loan expansion. At country banks the other sources of funds were not available to the same degree as at city banks. In order to maintain the same level of loan expansion in 1964 that existed in the first half of 1963, country banks this year found it necessary to reduce their investment portfolios at a little higher rate. As a result, total credit expanded at a slightly lower rate in 1964 at country banks than it did the previous year.

Although loan expansion at city banks was about the same in the two six-month periods under review, there were some significant changes within the loan classification. In the first half of 1964 business loan repayments exceeded extensions by $6 million, a sharp reversal of the trend of last year when, for the comparable period, extensions exceeded repayments by $31 million. More than offsetting the amount of business loan contraction in 1964, however, were the increases in loans to nonbank financial institutions and consumer loans. One factor behind the sluggishness of business loans was the unwillingness of district commodity dealers to build up inventories in the first half of 1964 due to price uncertainties existing under the current wheat legislation act.

WHEAT CROP PROSPECTS

The July 1 Crop Production report of the U. S. Department of Agriculture indicates that the district wheat production will be considerably larger

FEED LOT NUMBERS DOWN

District cattle feeders cut back their total number on feed lots to a greater extent than was true for the entire U. S. livestock feeding area. According to a July 1 U. S. Department of Agriculture report, sharp declines relative to a year earlier in Minnesota and North Dakota, and a lesser reduction in South Dakota, reduced the district's 4-state total by 6 per cent from July 1, 1963. As shown in the table, the only increase in numbers on feed as compared with last year was in Montana, a relatively minor feeding state. Over-all, the reduction in the 28-state major livestock feeding area was 3 per cent.

CATTLE AND CALVES ON FEED

	July 1, 1963	July 1, 1964	July 1, 1964 as % of July 1, 1963
	(thousand head)		
Minnesota	417	379	91%
North Dakota	108	96	89
South Dakota	258	250	97
Montana	34	44	129
4 States	817	769	94
28 States*	6,882	6,665	97

*Includes major cattle feeding states.

Of the total number of cattle and calves which were on feed in the district on July 1, it is expected that 48 per cent will be marketed from July through September. If realized, that percentage will represent a shift away from last year's marketing pattern when 40 per cent of the cattle on feed on July 1 were marketed during that period. A shift to earlier marketings is also expected in the 28-state major feeding area where July-September marketing are expected to reach 59 per cent of the total number of cattle and calves on feed as compared with 54 per cent during that period in 1963.

RETAIL SALES

On the basis of preliminary data, district retail sales improved during July. Sales at department stores (the only available figures) were strong. Weekly sales in the Twin Cities and in the Duluth-Superior metropolitan areas were up 11 per cent, 16 per cent, and 15 per cent in the first three weeks in July, respectively, from the comparable weeks of last year. Sales were also significantly higher than for June.

Commercial bankers, in a survey conducted in mid-July, reported that in small urban centers, where farmer's purchases are important, there was a marked rise in total retail sales. Bankers attributed this rise to an improved outlook for farm crops -- since the early part of June, most regions had recorded enough rainfall to eliminate the drouth conditions that had developed during May. (Some regions are again beginning to suffer from drouth due to a lack of rainfall in July.) The sale of automobiles did not rise as universally as general retail sales, but were reported to be holding up well. In the large commercial centers and in the mining regions, bankers estimated general retail sales to be either at the same level or up in July from the former month. Automobile sales showed no evidence of weakening.

Although sales improved in July, total retail sales in district states still may not have reached the dollar volume of a year earlier. Estimates on total retail sales for the district are now available for the first four months of this year from the U. S. Bureau of the Census. In March and April the volume was down 11 per cent and 8 per cent, respectively, from a year ago. The largest percentage decrease occurred in building materials and farm equipment. Smaller decreases occurred in the categories of general merchandise stores, food markets, automobile dealers, gasoline service stations, eating and drinking places, and drugstores, indicating that the decline in volume was quite general.

Bankers in small urban centers report that farmers in July were probably spending less than last year and considerably less on major items such as machinery. Retail lumber yards report a decline in district lumber sales through June, reflecting the slow down in residential bulding.

Information on department store sales by district states indicates that the volume slumped sharply in the western half of the district where farm income is down. Beginning in March sales in both North Dakota and South Dakota, and beginning in April sales in Montana, fell below the volume of a year earlier. In the other district states, as well as in the nation, these sales have remained above the receipts of a year ago.

In the United States total retail sales during the first and second weeks of July were up 11 per cent and 8 per cent, respectively, from the corresponding weeks of last year. These percentage increases were larger than in June and, if comparable increases are realized in the latter half of the month, seasonally adjusted July retail sales will continue the upward trend. U. S. seasonally adjusted total retail sales in June were estimated at $22.2 billion, virtually unchanged from the record volume in May, and 6 per cent above the total for June 1963. Adjusted durable goods sales were down 3 per cent from May to June, attributable primarily to a decline in automobile dealer sales which was due, in part, to shipments from assembly plants in some eastern states being limited by a trucking strike. Nondurable goods sales rose 2 per cent in June.

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