Ninth District Quarterly

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Financing Rural Enterprise

The trend toward large-scale farming and the need for new business and employment opportunities have strained the financial resources of many communities in the predominantly rural Ninth District. Since rural banks supply most of the credit used by farmers and small business owners, changes in banking structure or practice which strengthen rural banks may also improve the financing of rural enterprise.

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Review & Outlook

First Half '74
Coasting on its first-quarter momentum, the Ninth District's economy continued to run stronger than the U.S. economy through the half. Most district sectors seemed slightly weaker in the second quarter than in the first, but all averaged better first halves than their national counterparts.

In the farm sector, continued high crop receipts produced personal income gains far greater than the national average. As crop receipts deferred from 1973 continued to roll in during the first half, both consumer spending and savings at ag banks rose faster here than in the rest of the country. Wage and salary employment in ag-related areas increased nearly 7 percent January-May from a year ago.

District manufacturers also enjoyed a strong first half. Sales expectations for the second quarter were in the 16 percent range, considerably higher than the 9 percent sales gains expected nationally.

Consumer-type time and savings deposit growth at district member banks bettered comparable national increases during the half, and loans grew about as fast at district and national banks.

But S&Ls had a rougher time of it. Savings inflows at district S&Ls slowed so drastically in the second quarter that mortgage money virtually dried up in states with interest rate ceilings.

And the lack of mortgage funds, combined with cost overruns and material shortages, crippled the district's housing industry. Housing unit authorizations were down 10.3 percent from a year ago through June. Residential construction nationally was noticeably worse.

Second Half '74
The surprisingly strong first half will undoubtedly lead into a somewhat weaker second half.

There are no signs that savings inflows will pick up at S&Ls, so any upturn in homebuilding will be further delayed.

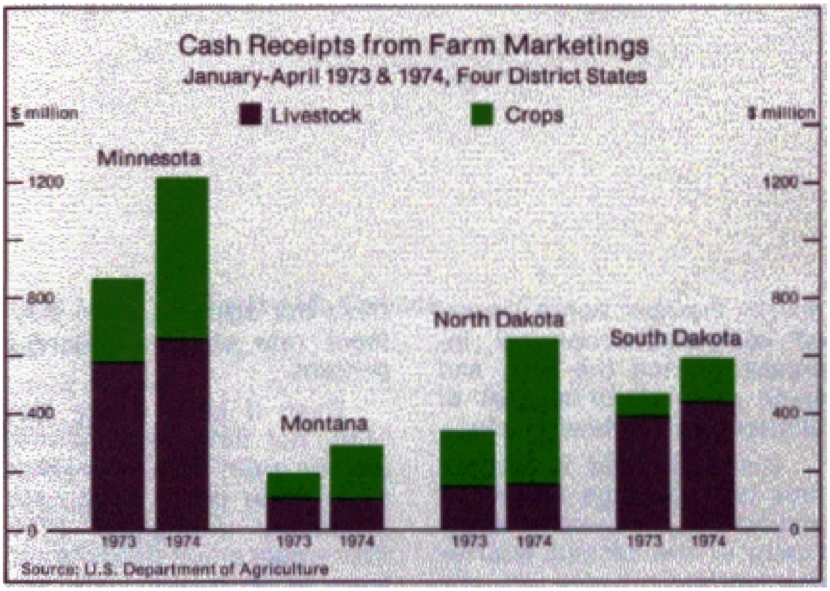
Some employment gains are expected in manufacturing, but the more rapid labor force expansion will probably push the district's unemployment rate above May's 5.2 percent.

Even if farm prices stay high, net farm incomes may well be down from 1973 levels since input prices have risen constantly throughout 1974. This would affect deposits and loans at ag banks, rural employment and consumer spending.

Agriculture
Bad weather and falling livestock prices characterized the farm sector's second quarter.

At the beginning of the quarter the farm outlook was promising. Ninth District cash receipts through April were running 46 percent above a year ago, and farmers were looking forward to another bin-bursting harvest of feed grains, soybeans and spring wheat. But too much rain in May and June put planting far behind schedule and prevented some acreage from being planted at all.

All crops were damaged by the damp spring. Estimates for the 1974 corn crop were cut back from 6.7 billion bushels on March 1 to 6.4 billion bushels in late June.



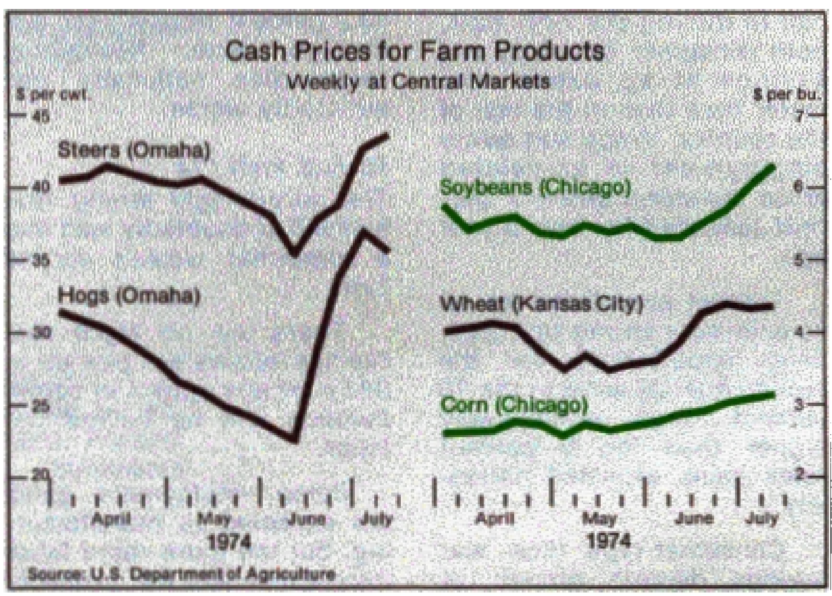
After a second revision in early July, the corn crop was expected to range between 5.95 and 6.35 billion bushels.

The 1974 wheat crop will also fall short of earlier expectations. Winter wheat production will apparently be about 12 percent greater than last year. But the projected harvest has dropped quite a bit, from 1.62 to 1.40 billion bushels. Expected production of spring wheat has also been revised downward, to 522 million bushels.

Even with lower yields, demand may be insufficient to keep wheat prices up: 1974-75 exports are a major concern. Export bookings reached 915.7 million bushels by July 6 last year. This year buyers are holding off, anticipating further declines in wheat prices. As of June 30, export sales from the 1974-75 crop amounted to less than 300 million bushels.

In the coming months, domestic demand for grains and oilseeds will depend on feeding rates in the troubled livestock sector. Developments through mid-June were not encouraging: Beef prices fell $4 per hundredweight between April 1 and early June, and an oversupply of beef was evident at all points in the marketing system. Beef stocks in cold storage on May 31 were 39 percent above those of a year ago. Despite the reduction in feeder placements, there was still an abundance of heavy cattle ready to come on the market on June 1. And qualitative reports indicated a buildup of cattle on the range. At midyear, however, cattle prices recovered to the low $40s.

In early July, Congress passed and sent to the President emergency loan legislation to help shore up the sagging livestock industry. The legislation provides for guarantees on loans to bona fide livestock producers.



These guarantees would cover 80 percent of the losses sustained by private lenders or other credit agencies, and authority to guarantee loans would extend for one year. The new legislation makes no provision for interest subsidies.

For much of the quarter, hog producers were having similar problems with lagging demand and falling prices. Prices in early June were down nearly 50 percent from the first of the year. But in mid-June the market reversed itself, prices rose sharply and losses incurred in April and May were recouped within a few days. A decline in marketings contributed to the turnabout.

A seasonal rise in milk production and an increase in imports depressed dairy prices below last winter's highs. Milk prices fell throughout the quarter. Cheese and butter prices declined to support levels, prompting a resumption of Commodity Credit Corporation purchases of these products.

Consumers had expected falling farm prices to ease inflationary pressures in the second half. While this may still happen, the outlook for consumer prices is less optimistic than it was three months ago. Much depends on the size of the 1974 harvest, which can't be accurately gauged until weather damage is known.

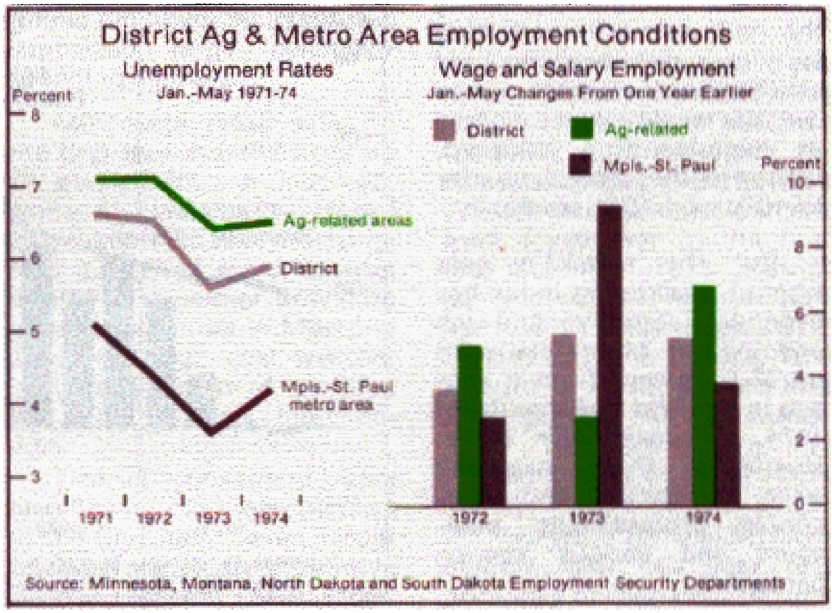
Even if an anticipated decline in feeding rates materializes, feed grain stocks will be tight through the summer, so feed grain prices should stay high. A decline in soybean acreage from 1973 and a strong export demand will hold soybean prices up through the second half. The wheat harvest promises to be of record proportions with light export demand. Nevertheless, wheat price declines may be slow in coming if farmers store much of the crop.

The large number of cattle on grass is likely to put downward pressure on beef prices for many months, but there may still be price gyrations if cattle cannot be moved to market in a more orderly fashion. Consumers may gain some near-term price relief as retail prices catch up with earlier declines in farm and wholesale prices. But farm-to-retail margins are unlikely to narrow substantially since much of the increase over last year's margins is probably due to the increased real cost of refrigerating and transporting meat products.

Although gross farm incomes in the district will hold strong until late in the year, net farm income should be down from last year because of higher costs.

Labor Market

The tremendous increase in agricultural incomes in 1973 and early 1974 has meant new employment opportunities for the predominantly rural Ninth District. In the district's agriculturally related areas (the four full states excluding Minneapolis-St. Paul and Duluth), wage and salary employment increased about 6.8 percent from a year ago in the



first half and the unemployment rate inched up just 0.1 percent. Comparable figures for Minneapolis-St. Paul, the district's largest urban area, showed only a 3.8 percent gain in wage and salary employment and a 0.6 percent jump in the unemployment rate.

Seasonally adjusted, the unemployment rate for the entire district matched the U.S. unemployment rate of 5.2 percent in the second half. But district unemployment has been rising more slowly, thanks to the booming farm sector. The district's unemployment rate was 5.1 percent in the second half of 1973; the U.S. rate was 4.7 percent.

Some softening in district labor market conditions has appeared in nonagricultural areas. District initial claims for unemployment insurance increased 16.0 percent during the half, primarily reflecting layoffs of manufacturing and construction workers. And average weekly hours worked in manufacturing declined, falling in the second quarter to 1970 and 1971 levels.

But the district's help wanted advertising index has expanded recently, and job openings in Minnesota were up 26.5 percent from a year ago in the first five months of 1974. Approximately three-fourths of these vacancies were for clerical and sales people, professionals, managers and various service personnel.

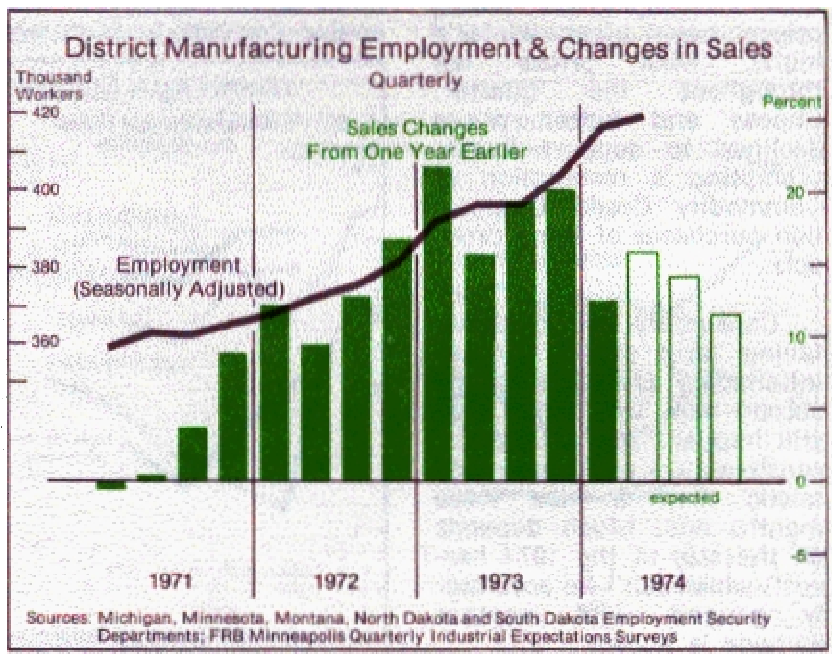
Because the prospects for farm incomes are so uncertain, district employment growth may fall off in the second half. The decline of hours worked in manufacturing and slump in the construction industry contribute to this outlook. Few new jobs are expected in the large trade and service sectors either, so it seems likely that the unemployment rate will move higher as the year ends.

Industrial Activity

District industrial sales and employment have been growing rapidly since early 1972. According to our May Industrial Expectations Survey, manufacturers in this area realized a 12.7 percent sales gain in the first quarter and expect a 15.9 percent increase in the second. A comparable survey of national manufacturers showed a 12 percent first-quarter sales gain and an expected 9 percent second-quarter advance.

The strength in district manufacturing activity came from the durable goods sector. Sales of durables were up 14.4 percent in the first quarter and are expected to rise 21.2 percent in the second. Nondurable goods sales should surpass last year's levels by about 10.5 percent during the first half.

Total district manufacturing employment was up 6.2 percent from a year ago during the first half of 1974, as 7.8 percent more jobs were created in durable goods industries and 4.1 percent more in nondurables. National



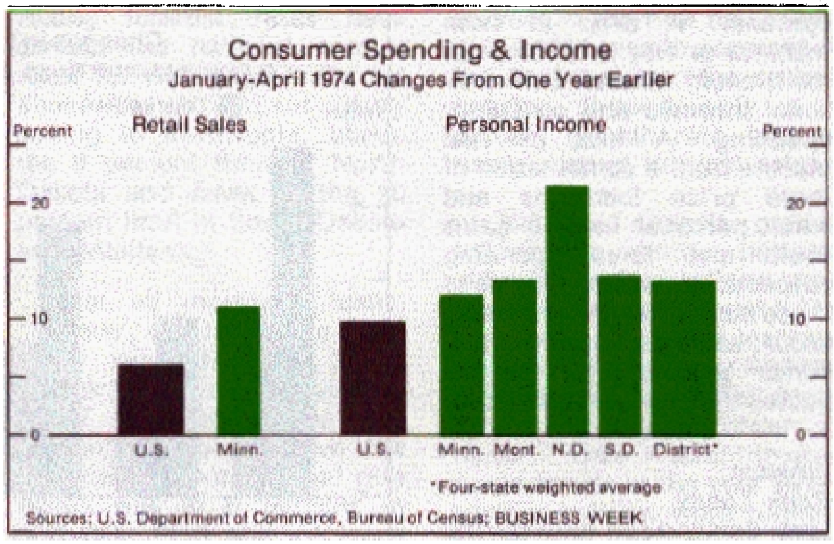
manufacturing employment was essentially unchanged due to energy crisis layoffs.

District manufacturers have been facing material constraints over the last year. But the number of respondents who felt their present inventories were too low has dropped from the 1973 high of 28 percent in November to 23 percent in May 1974. In May of 1971 and 1972, for comparison, only 10 and 15 percent of the respondents were dissatisfied with their inventories.

Manufacturers did not report much improvement in their plant and equipment situation. For two years a third of our respondents have felt their capacity was inadequate to meet expected sales demands. In May 1972, only 20 percent shared this view.

Since first-half sales figures are much higher than could be expected given material and capacity constraints, some of these increases must be due to inflation. Nevertheless, the substantial growth in manufacturing employment over the past 12 months indicates that some real growth has occurred.

Future manufacturing sales expectations of 14.2 and 11.5 percent in the third and fourth quarters, respectively, must also be deflated by price increases. There will certainly be some expansion, but the number of new jobs that can be created in the second half will still be restricted by material shortages and capacity constraints.



Consumer Spending
Consumers seemed to be better off in the Ninth District than in other parts of the country during the first half. High farm incomes and continued employment expansion supported large consumer spending increases.

Minnesota retail sales in the first four months were up 11 percent from a year ago, while U.S. sales advanced only 6 percent. And according to a survey of major district retailers, consumer spending growth continued in May and June, although cool weather hurt early sales of clothing and other summer merchandise.

District consumers were also buying more automobiles in the first half. Seven Upper Midwest regional sales managers reported that their share of the national market has been increasing, thanks to a combination of personal income growth in rural areas and adequate fuel supplies. They are having no problems with excessive inventories and may even be unable to satisfy customer demands this summer.

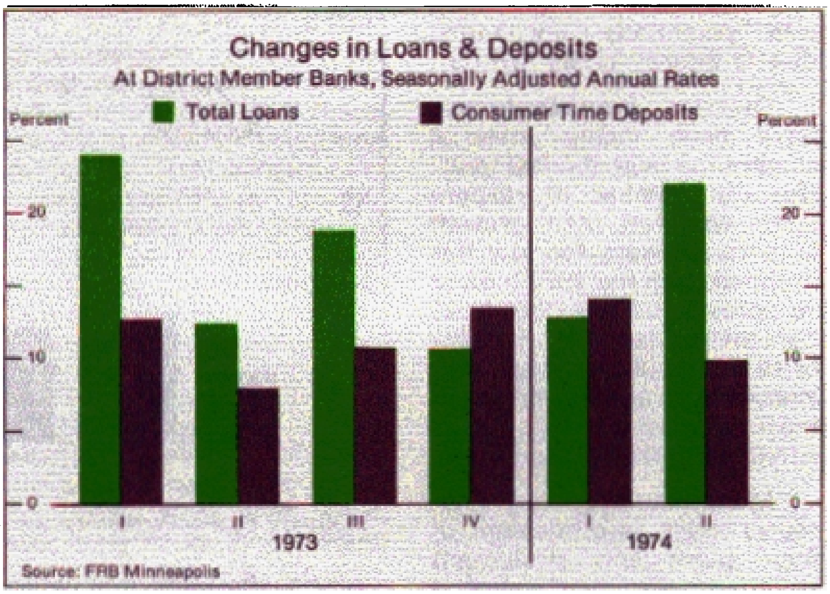
Personal income data largely explain the continuing rise in district consumer spending. U.S. personal income, according to BUSINESS WEEK, increased 9.7 percent from a year ago in the first four months of 1974. District gains were all larger—12.2 percent in Minnesota, 21.5 percent in North Dakota, 13.8 percent in South Dakota and 13.5 percent in Montana. Price increases have, of course, eroded much of these gains.

Prospects for district consumers later this year rest primarily on personal income growth and inflationary developments. A drop in farm incomes or rise in unemployment could weaken both personal incomes and consumer spending. A loss of real income from a combination of large price increases and small personal income gains could also force spending cutbacks. Since one or more of these conditions will probably occur, some reduction in consumer spending can be expected during the second half.

Finance
Bank Loans
Loan demand ran high during the first half and district member banks responded, issuing loans at a 16 percent seasonally adjusted annual rate.

Business loan demand, much of it originating outside the district, was particularly keen in the second quarter. Real estate investment trusts and other national borrowers apparently used lines of credit at district banks when unable to obtain funds in the commercial paper market.

Regional business loan demand was also strong, increasing 6 percent (not seasonally adjusted) at small weekly reporting banks in Minneapolis-St. Paul and at the six smaller regional centers in the district. Construction companies, plagued with cost overruns, material shortages and cancellations of take-out loan commitments by permanent lenders, were major loan customers at Twin



Cities banks in the second quarter.

In the months ahead, if firms try to increase inventories and expand plant and equipment, regional business loan demand is likely to remain strong.

Loan demand at agricultural banks has been heavy despite the potential for increased equity financing by farmers. Loans outstanding increased 6.3 percent over the first five months of 1974, slightly faster than in previous years. Merchant credit has been hard to get and interest rates on Production Credit Association (PCA) loans have been high, resulting in a shift toward bank borrowing. PCA loans outstanding in the Ninth District grew only 0.6 percent over the first four months of 1974; bank loans outstanding increased 4.7 percent. Nationwide, PCA loans outstanding were up 8.3 percent.

Bank Deposits
Consumer-type time and savings deposits at district banks increased at a 13 percent annual rate in the first half. Deposit growth slowed in the second quarter but was still stronger than at banks outside the district or at district S&Ls, probably because district banks draw a greater proportion of their savings from rural areas where incomes are high and interest rate sensitivity seems to be lower.

Large regional center banks stepped up their acquisition of negotiable CDs during the half to meet loan expansion and offset demand deposit losses. Large CDs increased 45 percent from January to June, much faster than the national average.

The aggregate loan-to-deposit ratio of district rural and small urban member banks remained at a seasonally adjusted 64 percent from November 1973 to May 1974, reflecting strong but equal growth rates for loans and deposits. In the preceding six months, the ratio had risen from 61 to 64 percent.

Country banks have reduced net federal funds lending and have been borrowing more heavily from the Fed in recent months. Reasons for these borrowings ranged from offsetting losses due to the low interest rate ceiling on time deposits in North Dakota, to accommodating higher farm loan requirements because of increased production costs, to financing increased cattle inventories caused by depressed prices.

S&L Loans and Deposits

A slowdown in the growth of deposits at district S&Ls during the second quarter, coupled with statutory limitations on mortgage loan interest rates, has sharply curtailed the supply of mortgage funds in the district. In mid-July conventional mortgage loans in the Twin Cities were either not available or made only with a very high down payment. FHA and VA mortgage loans were still being supplied, but the $33,000 maximum on FHA mortgages was insufficient for many homes on the market.

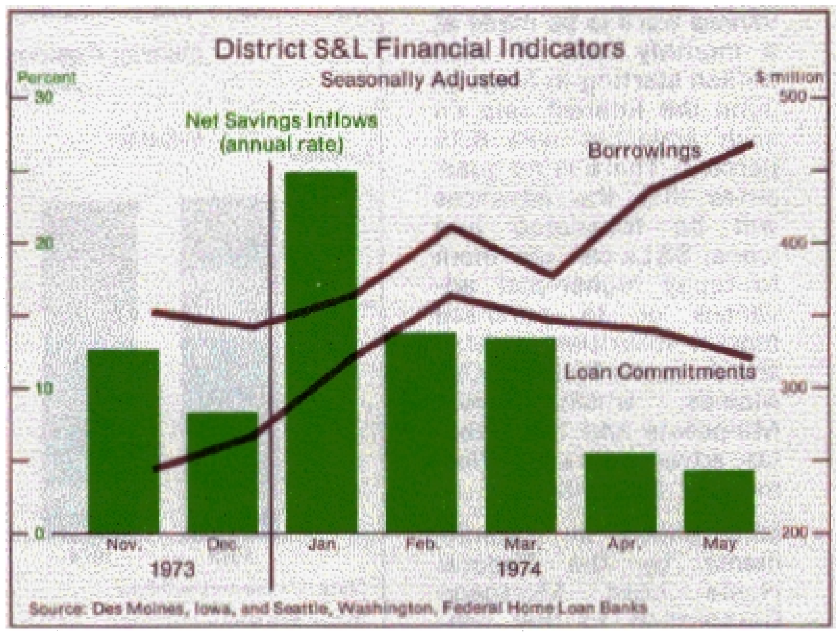
The scarcity of conventional loans partly reflects the impact of state usury laws. Rising interest rates have carried the national market rates for mortgage loans far above the 8 percent usury ceiling in Minnesota, above the 9 percent limit in North Dakota and close to the 10 percent limit in South Dakota and Montana.

Not all mortgage loans, however, are subject to state usury laws. National banks are permitted to make conventional mortgage loans one percentage point above the Federal Reserve discount rate which was at 8 percent in mid-July. FHA and VA loans are also exempt from usury laws, and in mid-July the rate on these loans was 9 percent plus 5 to 6 points.

Savings deposits at district S&Ls increased at a seasonally adjusted annual rate of 11 percent in the first half. Most of the 1974 growth occurred in the first quarter; the second quarter showed only a 5 percent growth rate, due to rising market interest rates.

National deposit growth followed a similar pattern, although savings inflows were generally lower. District S&Ls have been obliged to increase borrowings from their Federal Home Loan Bank (FHLB) in recent months in order to honor loan commitments made earlier in the year when savings inflows were higher. To protect themselves from further borrowing, S&Ls have reduced new loan commitments.

As long as market interest rates stay well above Regulation Q ceilings, savings in-



flows at financial intermediaries will not improve. District net savings inflows could be depressed even further if farm incomes decline.

Federal Aid

Because the financial situation has been so tough on both prospective homebuyers and the construction industry, the Administration sponsored a plan to provide up to $10.3 billion to lenders making home mortgage loans at below-market interest rates. The plan, which could potentially finance more than 300,000 new and used housing units, consisted of the following:

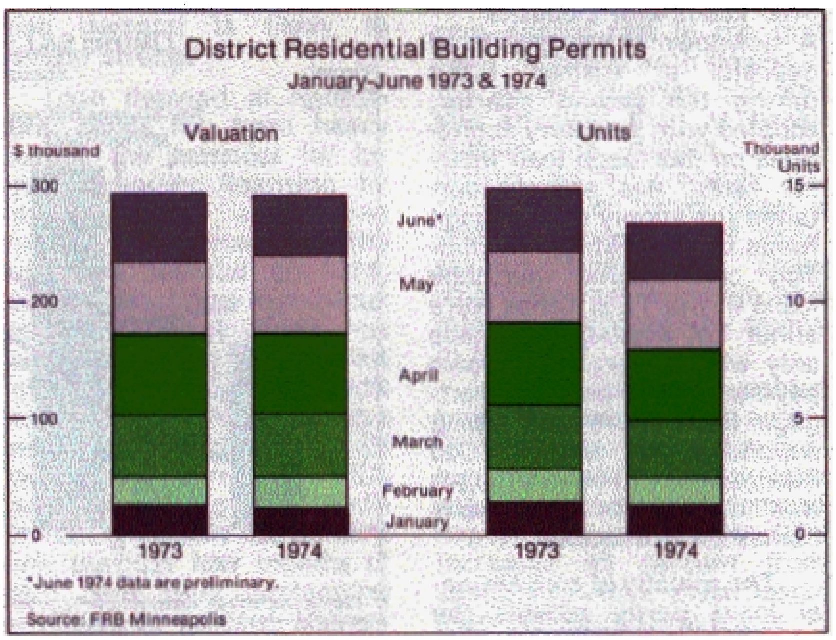
- $4.0 billion in 5-year advances by FHLBs to S&Ls at one-half of a percentage point below the FHLBs' cost of obtaining the funds in the market. The advances were to be made at a monthly rate of $500 million starting in May. In June the interest rate on such advances was 8.15 percent. There is no guarantee that the advances will be translated into loans; S&Ls can use them to repay higher-cost advances or to purchase market securities. In May and June the FHLB of Des Moines, which covers Minnesota and the Dakotas, advanced its full allotment of $60 million.
- $3.0 billion in commitments by the Federal Home Loan Mortgage Corporation to buy conventional loans on 100,000 newly built housing units. Initially, the interest rate was set at 8.75 percent and the maximum amount of each mortgage at $35,000. The entire amount was committed by mid-July.
- $3.3 billion in commitments by the Government National Mortgage Association (GNMA) to buy 8 percent FHA-VA loans on 100,000 newly built units. At the time of the announcement, GNMA still had unused funds under a previous plan to purchase 7.75 percent FHA-VA mortgages.

It is not likely that this program will materially increase the supply of mortgage loans in the Ninth District—particularly in Minnesota since the subsidized rate on borrowings and conventional loan commitments is still above Minnesota's usury limit. The subsidy on FHA-VA loans, however, may result in some loan expansion, especially of VA loans which are not limited by size.

Construction

The construction industry showed few signs of a second half recovery. Through April, the value of Ninth District contracts was about 8.1 percent below last year's level and U.S. contracts were down 5.3 percent. But since higher costs inflated valuation totals, the real declines were even greater.

District building permits data illustrate the impact of rising costs: the total number of nonresidential permits



through June was essentially unchanged from a year ago, yet valuation was up nearly 12 percent.

While construction generally fared poorly, the situation was bleakest in the homebuilding industry. Residential contracts in the district through April were valued 16 percent below a year ago. (Nationally they were 21.9 percent lower.) District housing units authorized by building permits in the first six months fell 10.3 percent, although valuation declined less than 1 percent. Only in the Minneapolis-St. Paul area were units running slightly ahead of 1973.

The difficulties in housing stemmed mainly from supply and credit factors. On the supply side, both building materials and labor were more expensive. Although lumber prices have stabilized, brick, steel and cement prices were still climbing with the higher costs of energy used in their manufacture. Reinforcing steel, for example, cost about 55 percent more than last year. The energy crisis also created a demand for better housing insulation, driving up the price of insulating materials. In addition, labor contracts settled in May and June contained wage increases of 8 to 10 percent.

On the credit side, tight credit terms made it more costly for builders to obtain financing. And although the number of potential homebuyers was apparently large, their ability to purchase was restricted by lack of credit.

Environmental considerations also influenced housing activity. One large Minneapolis private housing project has been halted pending court action on an environmental impact suit.

There's not much hope for housing in the second half. Even if rising construction costs moderate, high money market interest rates would still restrict the availability of mortgages. The major Housing and Community Development bill expected from Congress later this year will have little if any second-half impact on the district.

Financing Rural Enterprise

The postwar shift toward large-scale, capital-intensive farms, together with the need to finance new rural enterprises, has strained the existing financial structure in rural communities. The search for additional funding for rural areas has focused primarily on rural banks, which are often the principal suppliers of credit used by farmers and small business owners.

Rural credit demand is expected to increase as the trends toward larger farms and rural industrialization continue. The decision to use private financial institutions rather than federal credit programs to meet this demand seems to rest on the proposition that "the private sector can usually deal more effectively with novel credit demands or those that are unique to certain regions, or those that may require some departure from traditional terms or financing methods."[1]

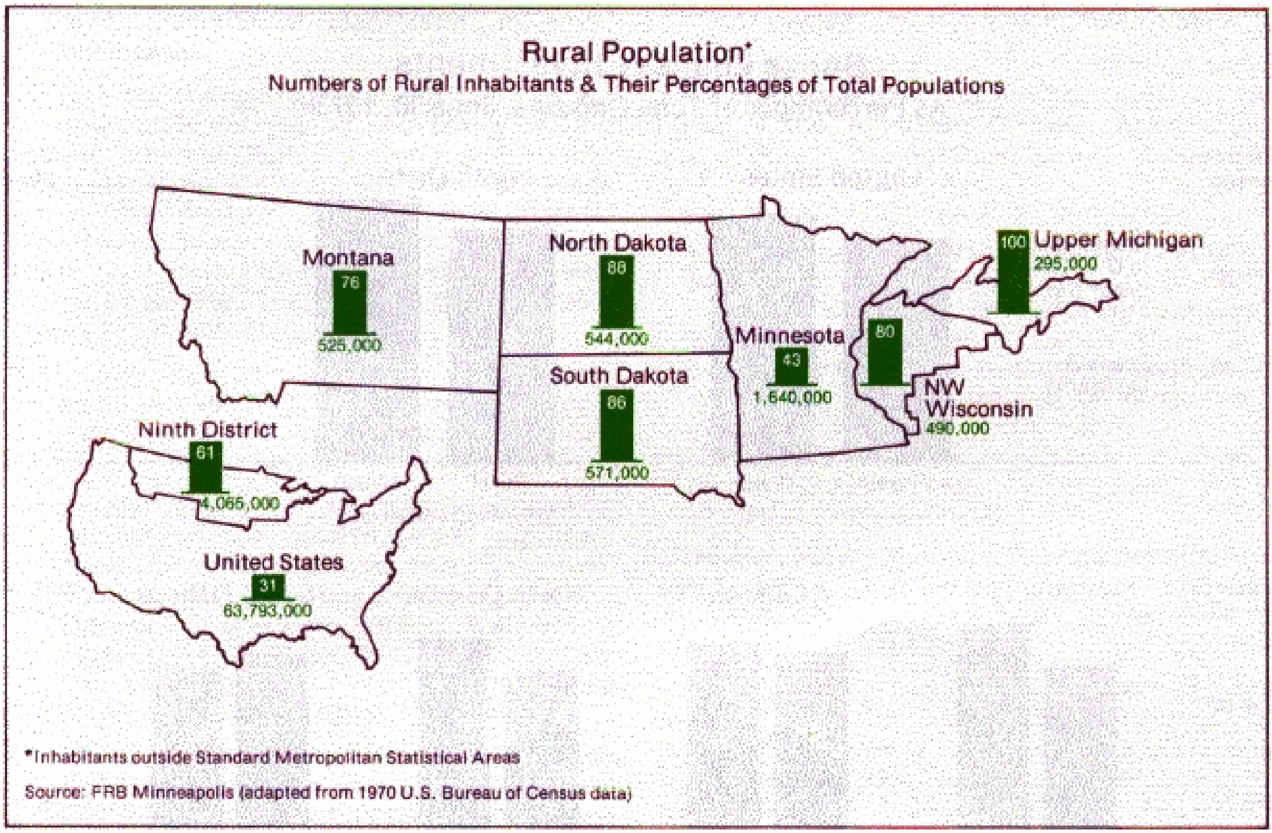
To determine how private financial institutions might be strengthened to better meet the credit needs of rural enterprise, it's useful to look at the role commercial banks now play in rural areas. One rough measure of rural banking activity is the loan-to-deposit ratio. Rural banks throughout the United States generally have a smaller percentage of their deposits loaned out than urban banks and a larger percentage invested. In the Ninth District, for example, the mid-1973 loan-to-deposit ratio was 58.6 percent for rural banks and 73.3 percent for urban banks, while the investment-to-deposit ratio was 15.1 and 10.4 percent. Since bank loans are often made locally and investments are typically made outside the area in U.S. government securities or federal funds, a higher loan-to-deposit ratio may mean a bank is taking a more active part in financing rural enterprise. In drawing this conclusion, however, it must be realized that the difference in rural and urban loan-to-deposit ratios may in large part be associated with differences in bank size.

The lower loan-to-deposit ratio at rural banks does not necessarily mean that rural areas are inadequately supplied with credit or that rural banks are operating inefficiently. Quite the contrary, it seems that

> ...the present setup has defects that impose significant disadvantages on institutions and their customers. Banks, for example, are often popularly blamed for lack of lenders' initiative or avoidance of the effort needed to make rural loans when they may, in fact, be partly or largely immobilized by internal constraints within the system. If we can find the faults and improve the system—if, for instance, we can change things so that rural financial institutions can make more efficient [effective] use of their present resources, or so that they can improve their access to the nation's main market flow of funds—then the rural economy will be the winner, at least to the extent its needs are competitive with other demands on the economy's credit resources.[2]

It has been argued that structural changes in the banking system are essential if rural

This paper was distilled from David Dahl's thesis, FINANCING RURAL ECONOMIC DEVELOPMENT: IMPLICATIONS FOR THE NINTH FEDERAL RESERVE DISTRICT, through the efforts of David Dahl, Charles Gray, John Rosine and Jeananne Struthers.

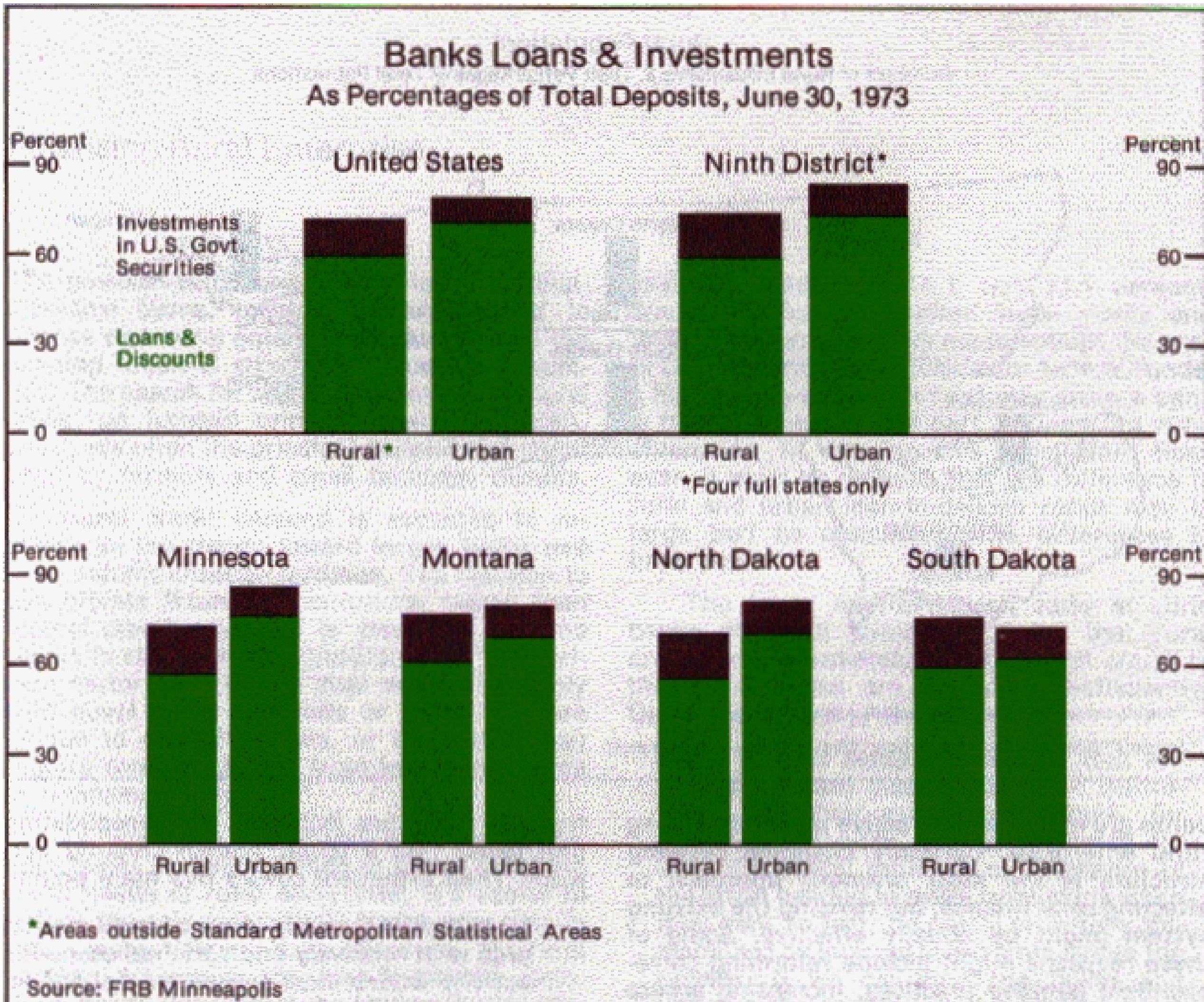


banks are to take a more active part in financing rural enterprise. Certainly changing banking structure is the most dramatic approach to affecting rural finance, but revising the existing system might be equally effective. Some of these revisions might include reforming correspondent banking practices, increasing access to national money markets and participating in the Federal Reserve's seasonal borrowing privilege.

Banking Structure
Rural areas, particularly in the Midwest, have traditionally been served by small unit banks. With the demand for larger rural loans, however, the resources of these banks have become increasingly strained. As a result, the entire unit banking system has come under fire. Some critics maintain that more credit could be extended to rural enterprises and the existing financial structure improved by consolidating unit banks into a larger branch banking network. Their argument covers five main points:

- Rural banks typically serve a small market area with relatively undiversified economic activity where most borrowers engage in the same enterprise or in related activities. Because the economics of these local rural businesses are interrelated, the risk confronting a rural bank is greater than if its loan portfolio were more diversified. A statewide branching structure would allow banks to diversify their loans across the state so that relatively more bank assets could be devoted to loans and hence more credit to local enterprise.

- Larger banks with branches are asserted to be more efficient than small rural banks.



Unit costs of very small banks—those with under $5 million or so in deposits—are significantly higher than unit costs of larger banks, and these costs must in some way be borne by their customers in the form of less service, higher loan rates or lower time deposit earnings. Consequently, it is argued, branch banking should lower the costs of banking services in rural areas.

- Many small rural unit banks cannot legally or prudently meet loan demands of larger businesses or farms in their areas. Rural branch banks would have access to resources enabling them to more easily accommodate such needs of the larger credit-using enterprises in the community.
- Larger banks with branches in rural areas have better access to loanable funds in the nation's capital and money markets.[3]
- Branch banking may tend to impose more competitive conditions where small local

banking monopolies now exist and provide lower commercial loan rates to small businesses.[4]

But the charges against unit banking are not universally convincing. Advocates of unit banking contend that branching and similar structural changes disrupt the close identification of rural bankers with their local market. They see little evidence that branch banking will provide better or more concerned service than unit banking. They counter the branching argument as follows:

- It may be true that rural banks serve a small market area, but they can diversify their portfolios through participations with correspondent banks.
- Studies do suggest that a large bank with one location may have lower per unit operating costs than a smaller rural bank with one location. But once branching occurs, the costs of operating smaller branches in several locations may be no different from the operating costs of several unit banks accounting for the same total assets.
- There is no guarantee that small branch banks in rural areas would be able to pull funds from larger urban banks in the system to make loans to rural enterprise. Studies have found instead that changes in banking structure "have not materially affected the amount or type of bank credit available in rural areas."[5]
- Evidence that rural branch banks have more access to national money markets than small unit banks is so far inconclusive. Advocates of unit banking argue just the opposite: branching does not transfer more money into rural areas, but instead enables deposits collected from rural areas to more easily be shifted to urban areas where credit demand and interest rates are higher.
- Claims that small unit banks tend to monopolize their communities are considered unjustified. Rural business people are quite mobile and can generally seek out the services of banks in neighboring areas if unsatisfied with their hometown banks.

Formal research by the Federal Reserve Bank of Philadelphia and the Agricultural Task Force of the American Bankers Association, among others, has not been able to resolve the controversial branching versus unit banking issue. The Philadelphia Fed found that:

> Examination of the most common indicators of economic performance does not reveal any systematic or readily discernible relationship between a state's style of banking structure and its tempo of economic growth. Some measures of economic growth and banking performance tend to favor states with statewide branching while other measures lean toward unit and limited branching states.[6]

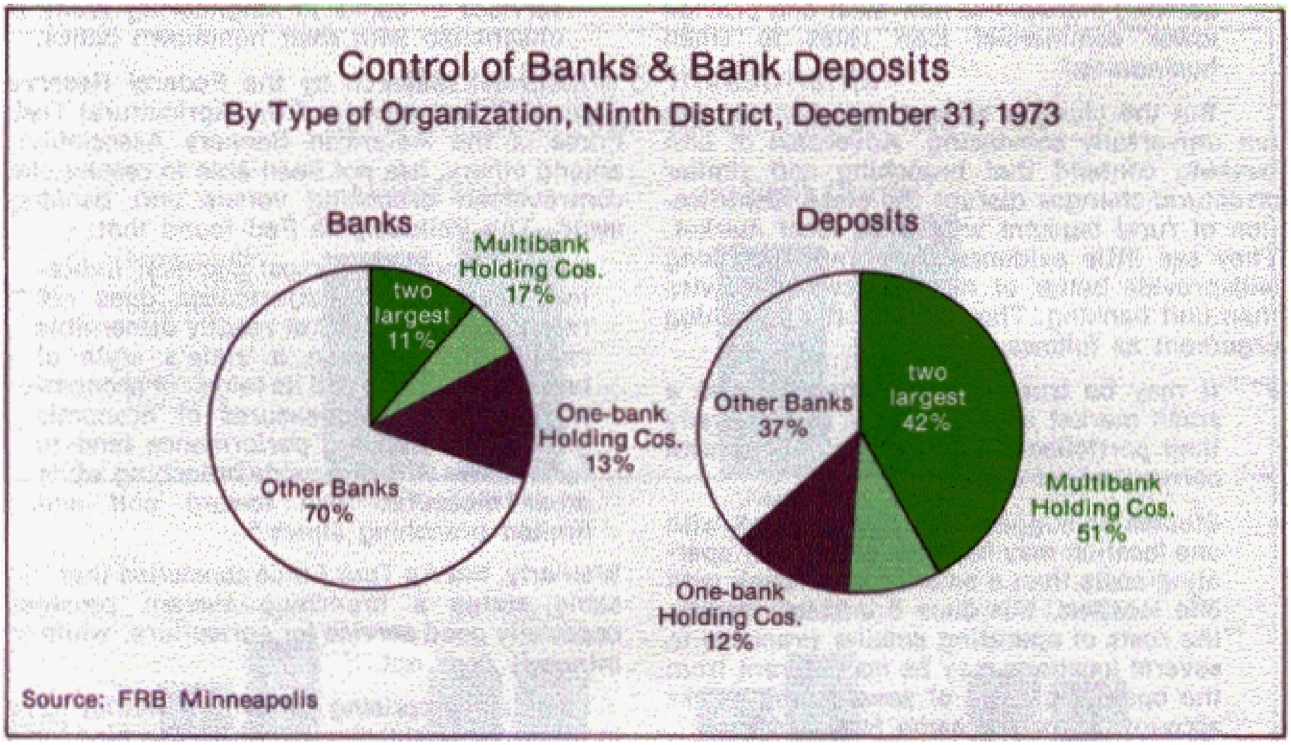
Similarly, the Ag Task Force concluded that "in some states a branching system provides especially good service for agriculture, while in others it does not."[7]

States comprising the Ninth District have in some ways sidestepped the branching/unit banking controversy by permitting multibank holding companies. Two large companies whose subsidiary banks hold approximately 42 percent of the district's commercial bank deposits dominate district banking activity.[8]

Multibank holding companies, in general, may provide some of the advantages of branch banking such as economies of scale through centralized administration of affiliate banks. They may also direct affiliates' investment policies. But perhaps the most important contribution holding companies make to financing rural enterprise is the ease with which affiliates can arrange loan participations. By splitting a large loan among several banks, affiliates can handle the credit needs of large-scale farms and growing businesses locally instead of turning these demands over to large financial centers.[9]

Correspondent Banking

Since the 1950s when rural banks had more loanable funds than loan demand, rural banks have had the option of keeping funds on deposit



with larger city banks in exchange for city bank services and in fulfillment of reserve requirements. Currently in the Ninth District, correspondent balances as a percentage of deposits range from a statewide average of 5.3 percent in South Dakota to 3.1 percent in Montana.[10]

Like the unit banking system, the practice of correspondent banking has been criticized for being unsuitably structured to meet rural credit needs. Money on deposit with city correspondents is, critics argue, money not being used to finance rural enterprise: "The rural banks' loan customers are clearly losers if the city banks' customers get access to the credit that they might have otherwise had access to."[11] Currently, city correspondent banks' participation in rural lending accounts for less than 3 percent of the agricultural credit extended by banks.

The Ag Credit Task Force finds that the primary impediment to involving the correspondent banking system effectively in agricultural lending is an "uneven understanding and appreciation of agriculture among senior management of city and rural banks alike...if this hurdle could be surmounted, other mechanical difficulties could be readily overcome."[12]

To improve the practice of correspondent banking, it has been suggested that rural banks purchase city bank services, retaining their own funds for loans to rural borrowers:

> Now that rural bankers in many sections of the country are serving credit-short areas they should be seeking city correspondents who are prepared to sell their services on a fee basis, thus allowing the rural bank to keep more of its funds at work in its own community.[13]

Access to Capital Markets

The nation's larger banks in recent years have been meeting a growing portion of their loan demand by raising funds in national and international money markets. Most rural banks are too small to participate in these markets, so their lending abilities depend primarily on local deposit growth. Slow population and employment growth in rural areas results in relatively slow deposit expansion and severely limits the lending ability of these banks. Consequently, as the demand for larger rural loans increases, rural banks may need to rely on funds raised in national money markets to facilitate credit flows.

The Agricultural Credit Task Force suggests two possible approaches rural banks might use to increase their lending abilities:

- Individual major banks or holding companies with the capacity to go directly into money markets for funds could establish such a corporation as a subsidiary.
- Smaller banks without direct access to money markets could jointly establish (by capitalizing on an expected individual basis) a regional or national agricultural finance corporation. Such an organization may or may not be backed by an existing banking regulatory agency.[14]

The first approach has been used by Central National Chicago Corporation, holding company for the Central National Bank in Chicago, which formed a Central Ag Finance Corporation to raise money for farm loans by selling commercial paper.[15]

Congress moved to allow the second approach in 1973 by enacting legislation enabling national banks to join together and form an agricultural credit corporation. Prior to this legislation, a national bank was required to own 80 percent or more of the stock of any corporation it organized or acquired solely to make agricultural loans. The new legislation permits national banks to own less than 80 percent of the stock in an agricultural credit corporation, providing not more than 20 percent of the bank's unimpaired capital and surplus are invested in the corporation.[16]

By virtue of Section 9 of the Federal Reserve Act, state member banks received the same new authority, provided that such investments are not prohibited by the applicable state law. The Agricultural Credit Task Force reports that many state laws already permit state banks to invest in agricultural credit corporations. In states where such investments are prohibited, it recommends enacting legislation similar to the federal legislation to strengthen the financial structure in rural areas.

Seasonal Borrowing Privilege

Rural banks generally serve communities where the economic base is dominated by a seasonal industry such as agriculture or tourism. "They most generally accommodate seasonal deposit and loan fluctuations by acquiring short-term assets during periods when seasonal pressures are low (deposits are high and loan demand low) and disposing of them as seasonal needs expand."[17]

This arrangement has two adverse effects on a bank's ability to lend. First, because the bank had to set aside funds to meet seasonal needs, the supply of funds available to satisfy intermediate- and long-term loans is limited: "the larger the allocation for seasonal needs, the smaller the allocation for longer-term loans such as business, mortgage, and consumer installment loans."[18] Second, rural banks only have a limited amount of funds to meet seasonal borrowing needs.

In order to modify this situation, the Board of Governors of the Federal Reserve System last year amended Regulation A—the rules relating to Federal Reserve lending operations—by providing eligible member banks a "seasonal borrowing privilege." Member banks can arrange to obtain funds from their Federal Reserve Banks on a temporary basis to meet seasonal credit requirements. Eligibility for these funds rests on four considerations:[19]

- The bank must lack reasonably reliable access to national money markets.
- It must demonstrate a seasonal need for funds arising from a combination of expected patterns of movement in deposits and loans.

- This pattern must persist for at least eight consecutive weeks.
- Fed credit under this arrangement will ordinarily be limited to the amount by which the bank's seasonal need exceeds 5 percent of its average deposits in the preceding calendar year.

Within the Ninth Federal Reserve District, Federal Reserve analysts have estimated that a high percentage of the 506 member banks may qualify for the seasonal borrowing privilege. Since the seasonal privilege is quite new, banks have only recently begun to take advantage of it in substantial numbers. The effect this provision can have on rural financing is somewhat limited because only Federal Reserve System members can use it; 64 percent of all banks in the district are not system members. Legislation proposed by the Board of Governors earlier this year would extend reserve requirements to all nonmember banks and would also give nonmembers access to the Fed's discount window and the seasonal borrowing privilege.

Conclusion

Many bankers, economists and government officials feel that numerous obstacles impede financial flows to rural America. But they have yet to agree on the best way to strengthen rural financial institutions.

Some observers, noting that the current rural banking system is ill-equipped to deal with the credit needs of modern large-scale farm and business enterprises, advocate structurally changing the present system. They view a branch banking system or a multibank holding company system as possible improvements.

But other observers feel that modifying the existing banking system is the best way to increase banks' lending ability. These observers advocate improvements in the correspondent banking system, greater access to national money markets and more widespread use of the seasonal borrowing privilege. The first and second alternatives can be implemented in large part by the banking industry. The third would depend upon changes in the Federal Reserve Act and federal or state legislation.

To date, empirical studies have not provided a clear basis for establishing which changes might best improve the existing system. It may be that there is no one best alternative, and if so, the future banking system might include both evolutions in bank structure and institutions and some of the options for legal reforms summarized here.

Footnotes

[1]George W. Mitchell, "Financing Rural Economies and Agriculture," speech delivered at the Farm Forum, Minneapolis, Minnesota, March 2, 1972 (mimeographed copies available upon request from the Board of Governors, Washington, D.C.), pp. 10-11.

[2]Mitchell, p. 2.

[3]Mitchell, pp. 17-18.

[4]For supporting opinions, see Lawrence Smith, MONEY, CREDIT AND PUBLIC POLICY, Houghton Mifflin Company, Boston, 1959, pp. 467-468, and Donald P. Jacobs, BUSINESS LOAN COSTS AND BANK MARKET STRUCTURE, Occasional Paper 115, National Bureau of Economic Research, New York, 1971.

[5]Thomas E. Snider, "The Effect of Merger on the Lending Behavior of Rural Banks in Virginia," JOURNAL OF BANK RESEARCH, Bank Administration Institute, Park Ridge, Illinois, Spring 1973.

[6]Jerome C. Darnell, "Does Banking Structure Spur Economic Growth?" BUSINESS REVIEW, Federal Reserve Bank of Philadelphia, November 1972, p. 22.

[7]REPORT OF THE AGRICULTURAL CREDIT TASK FORCE, Agricultural Credit Task Force, the American Bankers Association, Washington, D.C., June 1973, p. 15.

[8]Unpublished data, Research Department, Federal Reserve Bank of Minneapolis, December 31, 1973.

[9]Smith, pp. 473-474.

[10]Unpublished data, Research Department, Federal Reserve Bank of Minneapolis.

[11]Mitchell, p. 16.

[12]REPORT OF THE AGRICULTURAL CREDIT TASK FORCE, p. 14.

[13]Mitchell, p. 16.

[14]REPORT OF THE AGRICULTURAL CREDIT TASK FORCE, p. 16.

[15]Harold K. Street, "Rural Development to Test Loan Resources," AMERICAN BANKER, November 21, 1973, p. 6.

[16]"Rural Bank Credit," CONGRESSIONAL QUARTERLY, July 14, 1974, p. 1907, and a phone conversation with Senator Henry Bellmon's office.

17 "Seasonal Borrowing Privilege," NINTH DISTRICT CONDITIONS, Federal Reserve Bank of Minneapolis, June 14, 1973, p. 8.

18 "Seasonal Borrowing Privilege," p. 8.

19 "Seasonal Borrowing Privilege," p. 8.

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