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Stable Interest Rates, Ample Credit in 1998 & 1999

Rural and farm borrowers will benefit from increased credit availability and continued relative interest rate stability in 1998 and 1999. Enhanced credit availability will allow firms to more easily fund capital investment, which will boost rural competitiveness. Relatively stable interest rates will encourage farm investment by reducing the risk that capital costs will exceed expected returns.

In the first quarter of 1998, rates for farm nonreal estate loans from commercial banks averaged 9.1 percent, compared with 9.3 percent for 1997. In the 1990's, nonreal estate loan rates for farms have averaged 9 percent.

Interest rates that farmers and rural borrowers face are influenced by the level of interest rates in general as well as by individual loan risk and liquidity. National and global factors that affect credit demand and supply will in turn influence interest rates charged to rural borrowers. Domestic patterns of consumer savings and overall credit demand from businesses, homebuyers, and government all affect the general level of interest rates. In addition, U.S. interest rates in the 1990's have increasingly reflected flows of foreign capital into and out of U.S. financial markets.

Because commercial banks are the largest single category of lenders serving agriculture and small business, the availability and cost of bank loans to agriculture and rural small business is a key factor in rural growth. Surveys of large and small banks in 1998 indicate continued efforts by banks to expand business and farm lending—in part by maintaining low lending rate margins above their cost of funds for business loans. The Farm Credit System also appears very well capitalized and is willing to lend to creditworthy farm borrowers.

Bank Lending Rates Less Volatile in the 1990's

Interest rates in the 1990's have displayed less volatility than in the previous two decades. Nominal interest rates have been less volatile in part because real interest rates have risen less during the current economic expansion than is typical in such periods, while inflation—along with inflationary expectations—has declined. Since the end of the 1990-91 recession, real growth in the economy has generally progressed at a moderate to moderately strong pace, with declining overall inflation.

Typically, interest rates rise during economic expansion as business investment picks up in response to expected higher real returns on investment. As existing plant and equipment is used more intensely, businesses attempt to head off future capital shortages by increasing capital investments. In addition, high rates of utilization of capital and labor typically place upward pressure on inflation and inflationary expectations. Nominal interest rates rise as investors in fixed-income securities and fixed-rate loans demand higher interest payments to compensate for the increased risk of higher inflation.

Contrary to most expectations, annual inflation as measured by the GDP deflator fell between 1993 and 1997—from 2.8 percent to 2 percent. Lower inflation during this period has reflected stronger productivity growth from high levels of capital investment, a rising dollar since late 1995, corporate restructuring, and smaller increases in employee benefit costs.

Stability in bank lending rates in the current expansion has also been aided by monetary and fiscal policy. As a result, the Federal funds rate (the interest rate that depository institutions charge each other for use of their overnight bank deposits held at Federal Reserve Banks) has been much more stable in the 1990's than the 1970's and 1980's. The greater stability of the Federal funds rate, given its strong influence on other short-term interest rates, has reduced volatility in short-term rates. Bank loan rates are often tied to the bank's prime or directly to a measure of the bank's own cost of funds such as the Federal funds rate.

Also contributing to interest rate stability are declines in Federal deficit spending and a fall in real government spending since 1993, releasing additional funds to meet expanding private demand for credit. Loan demand by business firms at commercial banks has increased sharply since 1993, generated by the need to fund the strong growth in business investment. But despite sharply higher business and consumer loan demand, bank lending spreads (the difference between the bank lending rate and the bank's cost of funds) have fallen sharply for business loans since 1993.

Bank business lending spreads have fallen as borrower profitability and stronger balance sheets have reduced default risk.

Farm Finance

Record bank profits and strong bank capital positions have reduced the overall costs of funding new loans and have lowered the compensation that banks require for bearing various levels of default risk. In addition, bank business lending faces increasing competition from nonbank lenders, such as finance companies, and from direct financing that occurs in the national and regional credit markets through the issuing of new bonds and equity securities.

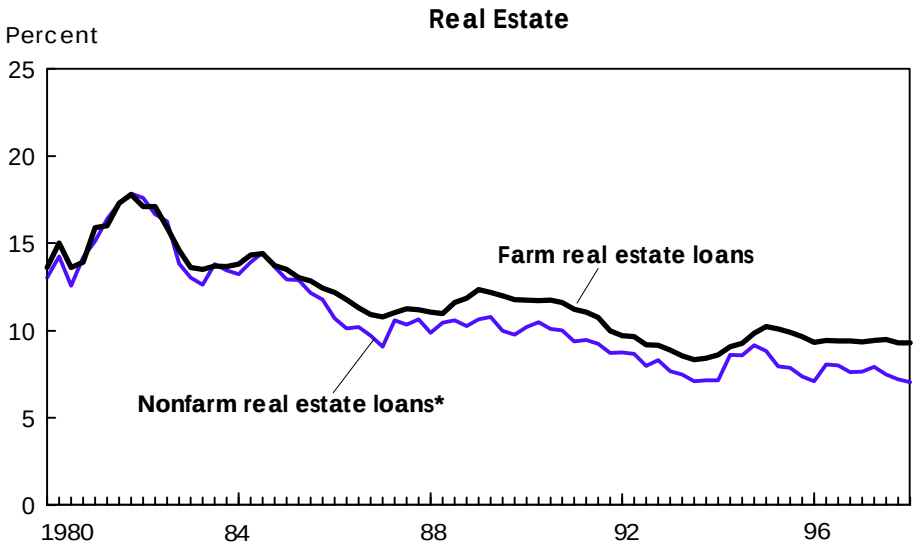
Outlook for Bank Rates In 1998 & 1999

While interest rates are expected to continue to be relatively stable by historical standards in 1998 and 1999, some mild upward pressure on long-term rates is expected in the second half of 1998 and in 1999. Economic growth is likely to slow significantly in the second half of 1998 to more sustainable long-term levels under the weight of the Asian downturn, a very strong dollar, slower inventory accumulation, slightly slower growth in business fixed investment, and tight labor markets.

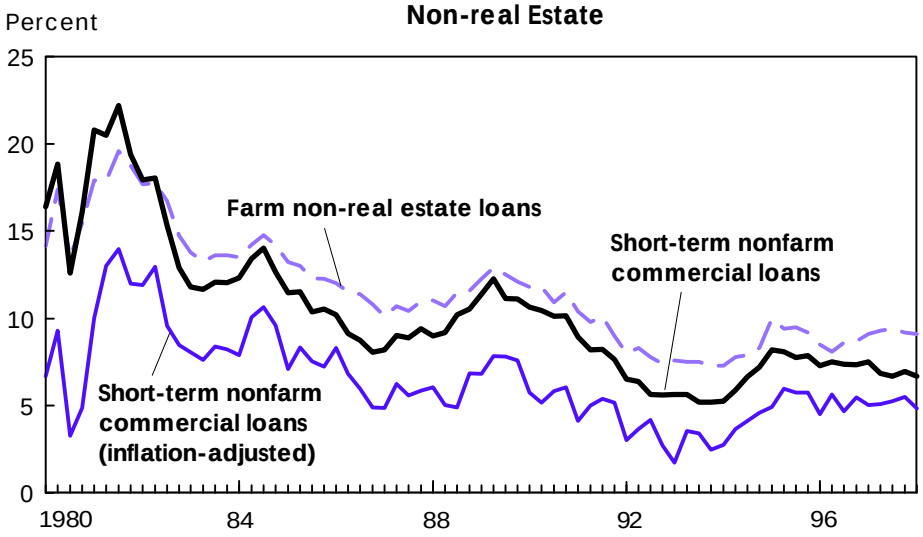
Moderate productivity gains, strong foreign competition, and lower oil prices (relative to 1997) should hold inflation to low levels. The combination of slower economic growth and continued low inflation is likely to leave monetary policy little changed in 1998 and 1999. Commercial banks and the Farm Credit System are both expected to aggressively compete for high-quality business and farm loans. Therefore, bank lending spreads for high-quality business loans are expected to remain narrow by historical standards.

The Asian currency and economic crises resulted in an increase in net foreign financial investment in the U.S., from $207 billion in the second quarter to $341 billion in the fourth quarter of 1997. As the Asian situation improves, this investment in the U.S. should slow, placing upward pressure on U.S. interest rates, especially longer-term interest rates. In addition, a mild increase in inflation is expected in the second half of 1998 and more notably in 1999 from continued tight labor markets and an expected mild depreciation in the U.S. dollar from current strong levels.

Interest Rates Have Been Relatively Stable for Agricultural And Other Loans



*30-year conventional residential mortgages.



Rates are nominal unless otherwise specified.

Economic Research Service, USDA

Any upward movement in farm or rural interest rates is expected to be smaller than any movement in general Treasury or most nonfarm lending rates. Rural banks are heavily dependent on consumer-type deposits, which respond sluggishly to changes in open-market interest rates. In addition, loan rates at rural banks typically respond more slowly to changes in open-market interest rates due to the greater importance of average cost-of-funds pricing in determining their bank fund costs.

Finally, farm balance sheets have improved significantly since 1995, improving the quality of farm collateral (especially farm real estate). Lower farm debt-to-asset ratios further lower farm default risk. Rural business balance sheets have also improved significantly in recent years, lowering the risk of rural loan default overall.

Interest Rate Stability: Impact on the Farm Sector

Farm borrowers and lenders rely on expectations of future interest rates in making investment and financing decisions. The greater the degree of interest rate instability or volatility—referred to as interest rate risk—the greater the likelihood and magnitude of forecast error.

Farm lenders' exposure to interest rate risk depends mainly on how they structure their balance sheet. As with most financial intermediaries, the maturity of rural lenders' assets is for a longer term than that of their liabilities—they "borrow short and lend long." Should interest rates unexpectedly rise sharply, lenders' cost of funds would rise while returns on their loans would remain fixed. Their net margins and net worth would suffer as a consequence. This is especially true for small farm lenders for whom net interest revenues account for an especially large proportion of profits.

Lenders have learned to reduce their exposure to interest rate risk using numerous techniques such as derivatives (futures, options, and swaps), variable-rate loans, or increasing their reliance on fee-generating services. But learning and applying these techniques raises the cost of lending to the rural community.

Stable rates allow lenders to try to "ride the (normal) yield curve," borrowing short at lower rates and lending at longer maturities with higher rates. Should rates remain stable over time, lenders can meet the maturity needs of both depositors and borrowers with considerably reduced risk. This classic function of a financial intermediary is limited when the lender tries to reduce interest rate risk exposure by constantly restructuring the balance sheet in a rapidly changing interest rate environment. In addition, stable interest rates reduce the need to learn and apply interest rate risk management techniques. This reduces the cost of lending to farmers and other rural borrowers and helps hold down the "risk premium" lenders add on to a loan's interest rate.

In addition, stable rates encourage the use of fixed-rate loans. Variable-rate loans decrease lender interest rate risk exposure at the cost of increasing borrower default risk. Fixed-rate loans have fixed cash outflows that allow borrowers greater certainty regarding their long-range interest expenses. Recent survey data have shown increasing use of fixed-rate loans in agriculture. Greater reliance on fixed-rate loans as a result of the stable interest rate environment will reduce farmer and rural borrower default rates.

Stable interest rates reduce the uncertainty involved in long-range investment decisions, such as purchases or improvements to farmland. The interest rate needed in order to discount the future cash flows resulting from a proposed investment project can be predicted with more confidence in a stable rather than volatile interest environment. Hence, stable interest rates encourage farm investment and adoption of new technologies, allowing farmers to produce at lower costs and increase profit margins.

The downside is that, in the desire to increase lenders' profits by casting overboard the costs of risk management, the farm sector ship is left exposed to financial icebergs of sharply rising interest rates that might lie ahead. This was among the lessons learned by the farm financial community in the 1980's.

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Upcoming in the June/July *AO* . . .

Farm Credit Use Up For 6th Straight Year