Farm Finance

Interest Rates on Farm Loans Likely to Fall Throughout 2001

In a development that may provide some relief for farmers nationwide, interest rates on agricultural loans are expected to fall throughout most of 2001. Average interest rates on farm loans from commercial banks should dip below 9 percent by midyear and may drift slightly lower in the second half of 2001.

Interest rates on agricultural loans are determined largely by factors outside the agriculture sector, although factors such as default risk, quality of loan collateral, loan size, and loan liquidity are also important in determining agricultural loan rates. Should U.S. economic growth in the second half of 2001 and the first half of 2002 strengthen as expected, interest rates on agricultural loans are likely to rise slightly in the winter or spring of 2002.

Overall, U.S. interest rates fell in the second half of 2000, reflecting slower economic growth and demand for credit. Growing foreign capital inflows, a stronger dollar, and larger Federal Government surpluses all served to push interest rates lower in the second half of 2000 by increasing the overall supply of funds available for lending. In January-April 2001, the Federal Reserve Board sharply eased monetary policy in response to a pronounced drop in economic growth and signs of further weakening in the economy. These developments put immediate downward pressure on interest rates by lowering interest rate expectations for 2001 and 2002.

By April 18, the Federal Reserve had eased monetary policy by lowering its Federal funds interest rate target by 2 percentage points. (The Federal funds rate is the interest rate on short-term borrowings of immediately available funds held at Federal Reserve Banks. In essence, depository institutions loan deposits to each other for the purpose of meeting their reserve requirements.) Lowering of the Federal funds target brought other interest rates down by lowering the expected Federal funds rate for 2001 and 2002 and by encouraging more rapid expansion in the supply of money and credit by depository institutions. Interest rates—especially short-term interest rates—should continue to fall through the first half of 2001. Sluggish economic growth in the first half of 2001 should slow the growth in the demand for money and credit, thereby encouraging additional easing of monetary policy.

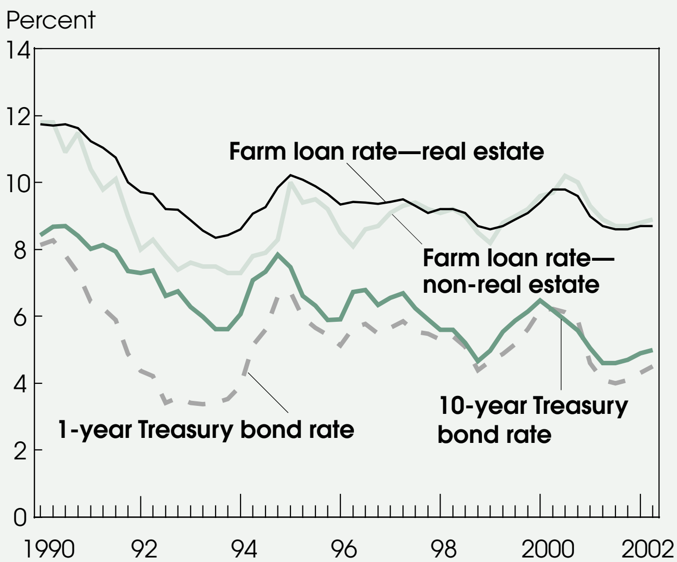
Interest rates, especially short-term rates, should continue to fall through the first half of 2001, and in general, credit growth should slow further. As manufacturers decrease production to slow the growth in business inventories, short-term business credit growth will slow. In addition, the supply of funds entering credit markets directly or indirectly from the household sector will rise if consumers, as expected, save more of their disposable income. However, economic growth is likely to increase significantly in the second half of 2001 and 2002 due to an easing of monetary policy and the accompanying sharply lower interest rates, reduction of excess inventories, gradually increasing stability in equity markets, and gradual improvement in business credit availability, in addition to an expected mild depreciation in the dollar.

Since 1999, short-term inflationary expectations have been quite consistent. Short-term median inflationary expectations (1 year ahead) have varied only by about 0.5 percent, while long-term median inflationary expectations (10 years ahead) have remained virtually unchanged at 2.5 percent, according to the Survey of Professional Forecasters. More stable overall inflationary expectations have resulted largely from stronger productivity growth, a strong U.S. dollar, and credible monetary policy designed to maintain low inflation.

Little change in underlying inflation or inflationary expectations in 2001 or 2002 relative to 2000 is likely as continued tightness in labor markets is largely offset by persistent excess capacity in manufacturing and somewhat lower energy prices. Continued strong, but slower, productivity growth and robust domestic and foreign competition will further moderate upward pressure on inflation.

Given the stability of inflationary expectations, the decline in both short- and long-term nominal interest rates since the first half of 2000 is due almost entirely to falling real interest

Farm Loan Rates at Commercial Banks Will Likely Fall For Most of 2001

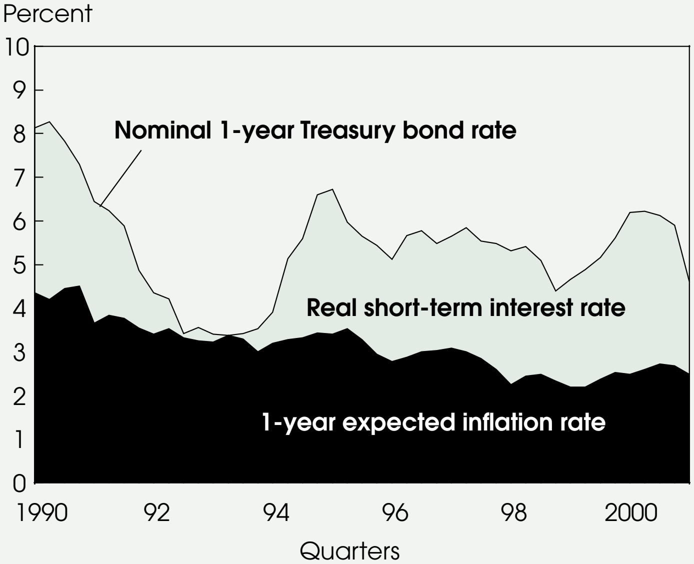


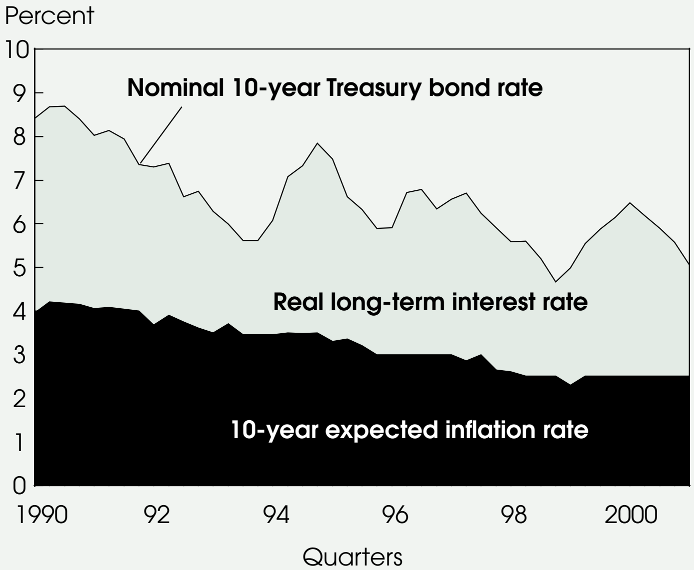
Nominal non-real estate loans and 1-year Treasury bonds are relatively short-term rates; real estate loans as well as 10-year Treasury bonds are relatively long-term. Forecast beginning 2001(II) for Treasury bonds; 2001(I) for non-real estate loans; and 2000(IV) for real estate loans.
Source: Federal Reserve Board of Governors.

Economic Research Service, USDA

Farm Finance

Short- and Long-Term Interest Rates Have Declined Sharply





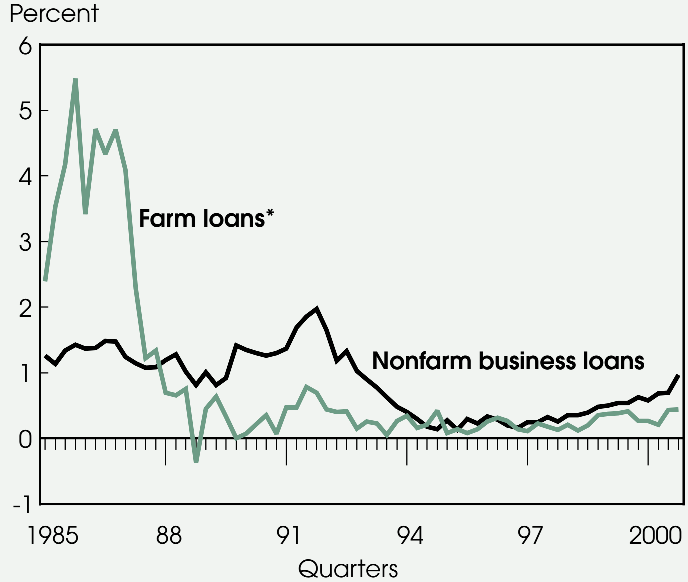
Expected inflation rates based on consumer price index for all urban consumers.
Source: For nominal Treasury bond rates, Federal Reserve Board of Governors. For expected inflation rates, Survey of Professional Forecasters (compiled by the Federal Reserve Bank of Philadelphia).

Economic Research Service, USDA

rates (the nominal rate minus the inflation rate). Consequently, the dip in interest rates since the first half of 2000 represents a decrease in the real cost of money and over time should encourage more borrowing.

Real interest rates in the first half of 2001 will be under downward pressure from both an easing of monetary policy and an expected increase in the rate of consumer saving out of personal disposable income. A higher personal savings

Charge-off Rate for Farm Loans Has Remained Low



Loan charge-off rate is the share of loans removed from total loan portfolios as uncollectable (bank incurs loss).
*Non-real estate loans.
Source: Federal Reserve Board of Governors.

Economic Research Service, USDA

rate will lower interest rates by increasing the supply of funds available in credit markets.

While the consumer savings rate was 2.2 percent in 1999, it fell to -0.1 for 2000. The consumer savings rate should rise to positive levels in 2001 in response to lower consumer wealth (caused by falling equity values), the large drop in consumer confidence since the third quarter of 2000, and rising consumer debt burdens. Consumer debt burdens—defined as principal and interest payments as a percentage of disposable personal income—rose appreciably in 1999 and 2000. Higher debt burdens, by reducing consumers' overall liquidity and ability to acquire additional debt, should be significant in raising the consumer savings rate in 2001 and 2002.

Both farm and nonfarm loan rates are expected to fall appreciably in the first half of 2001. Rates charged on farm loans in the long term must earn competitive risk-adjusted returns for lenders that are comparable to risk-adjusted returns from nonfarm loans and other financial assets. Therefore, the fall in real interest rates in the general economy will continue to place downward pressure on farm loan rates charged by private lenders. However, rates on farm loans will fall less than most interest rates in the general economy for a number of reasons.

First, rural banks are heavily dependent on consumer deposits (checking and savings accounts, plus time deposits of less than $100,000) for the bulk of their loan funds. Interest rates paid on these deposits typically respond sluggishly to changes in open market interest rates.

Second, changes in deposit interest rates typically affect loan rates at rural banks relatively slowly. Banks generally prefer to keep their small business loan rates more stable by determining their loan funds costs on an average cost-of-funds basis, thus keeping the interest rate margin fairly stable between the expected return from lending (expected interest rate paid by borrowers) and the expected average interest rate paid to depositors. Finally, given the overall weaker farm income outlook for 2001 and tighter credit standards and terms for business lending in general, some increase in risk premiums on agricultural loans are likely for 2001.

Default premiums on farm loans have been relatively low by historical standards. Furthermore, the charge-off rate (share of loans removed from a bank's portfolio as uncollectable) has been lower for farm loans in recent years than for general business loans. The relatively low charge-off rate for agricultural loans in the l990s reflected agriculture's diverse and expanding domestic and foreign customer base as well as government payments to agriculture that help support and reduce variability in farm income. A mild increase in the charge-off rate for agricultural loans in 2001 is likely.

With net farm income expected to decline in 2001 (due in large part to lower expected government payments to agriculture), overall farm interest expense as a share of farm income is expected to decline, making farm loans somewhat riskier. Furthermore, delinquency rates on nonreal estate farm loans rose slightly in the second half of 2000. Given the somewhat higher perceived risk in agricultural lending, the spread between interest rates charged on agricultural loans not secured by real estate and on those secured by real estate will likely widen slightly in 2001.

In summary, weaker overall growth in demand for credit, and increased overall supply of credit in the macroeconomy, will place downward pressure on farm interest rates in 2001. The fall in interest rates on farm loans will be less than for interest rates in general, due to rural banks' generally sluggish adjustment in consumer deposit interest rates, the desire of these banks to keep small business loan rates more stable, and an expected mild increase in risk premiums on farm loans. AO

Paul Sundell (202) 694-5333
psundell@ers.usda.gov

Revised farm income forecasts for 2001

May 25 on the Economic Research Service website

Farm Income and Costs Briefing Room

www.ers.usda.gov/Briefing/FarmIncome/

Click on "Farm income forecasts"

Check out other analyses and data related to farm income and costs