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CRITICAL ISSUES FACING FAMILY FARM OWNERS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SMALL BUSINESS: FAMILY FARM

OF THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

WORKSHOP ON FARM CREDIT POLICY

APRIL 27, 1983

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Dr. EDELMAN. Next is Mr. Emanuel Melichar from the Federal Reserve Board.

STATEMENT OF EMANUEL O. MELICHAR, FEDERAL RESERVE BOARD

Mr. MELICHAR. I will be referring to charts and tables that are in my prepared statement.

I will comment briefly on two areas that are important in considering farm policy: First, the profitability of farming and, second, the nature and incidence of recent cases of severe financial stress on individual farms.

Much flawed analysis of financial developments in farming stems from failure to distinguish between the total net income of these proprietorships, which is a combined return to their labor management and capital, and profits, which are the earnings of their capital alone.

The USDA publishes estimates of both results, but the total net income receives nearly all of the attention and is used in making analyses and drawing conclusions in many cases where the profits series is more appropriate and should be used instead.

For example, almost everyone is familiar with one statistic based on the profits series, which is that the return to total farm capital has been a relatively low 3 to 4 percent, not only recently but also on average over the last three decades. But think about that: The total farm capital earned 3 percent in 1955 and again 3 percent in 1980. Earnings, the numerator of the ratio, therefore, must have risen just as fast as the market value of farm assets, the denominator of that ratio.

These are the earnings before interest shown in the top panel of chart 1, plotted in dollars of 1982 purchasing power.

In addition to observing the strong upward trend, note that farm programs in place during the aftermath of the farm booms of the 1940's and 1970's prevented a repetition of the utter collapse of earnings that followed the boom of World War I. Such a collapse probably again would have been the market's way of forcing farm production to adjust to a lower postboom demand for farm products. Also note that, even though earnings before interest have recently been fairly well maintained, sharply increased interest payments have substantially depressed earnings after interest.

I want to discuss that credit development in detail but, first, a closer look at the relationship between earnings and the value of farm assets is warranted in view of the immense importance that understanding this has for farm policy considerations.

In the top panel of chart 2, earnings and assets are plotted with the scale for assets set at one-twenty-fifth of the scale for earnings so that, if the two lines are at the same level, it means that assets are selling at 25 times earnings or, alternatively, that the rate of return is 4 percent. The chart shows that these values have been roughly the average values over time.

It is also clear that asset values, which mainly means farm land prices, follow the trend in earnings. When the relationship during the boom of 1941–52 is compared with that during the boom of 1972–79, one also concludes that expectations of the future course

of earnings is a primary influence on asset values, with the cost and availability of credit playing only a secondary role.

During both boom periods, credit to purchase land was available at relatively low real interest rates. During the first boom, however, a postwar collapse in earnings was widely expected, and so the rise in asset values and the use of debt were relatively moderate.

During the second boom, when there was widespread optimism about future growth in farm earnings, asset values were bid up to a level that fully reflected expected continuation of the steep 1954–79 earnings uptrend, and credit was freely used in farm investments. Policy making credit readily available facilitated transactions, but the impetus for the rise in land prices was provided by optimistic earnings expectations rather than credit policy.

For farm policy in general, the important lesson from chart 2 is that the return to farm capital is determined in the farm real estate market, and that it has been relatively low at least in part—perhaps in great part—because the price of farm land reflects the very good long-term record of earnings growth.

In other papers I have noted the analogy between purchases of farm land and what Wall Street calls "growth stocks." Farm land, since it has been producing rising earnings, sells at a high price-earnings ratio, making it very difficult for an initial purchaser to live off those earnings. As with growth stocks, as those earnings grow and one gets past the first 10 years or so, the earnings will have risen to the point where they provide a very good return on the original investment. However, that does make things very tough for beginning farmers. Also, it makes things tough for policymakers who want to assist people such as beginning farmers because, if you try to raise farm income, this may, actually raise the price-earnings ratio at which land sells. That presents quite a dilemma.

I now return to recent credit developments. When, not too long ago, the average indebted farmer was earning 4 percent on capital and paying an interest rate averaging perhaps 7 percent, his operation was viable in view of the ongoing growth of real earnings and asset values, and often downright lucrative because the prevailing level of general price inflation was not fully reflected in the interest rate being paid.

By 1982, however, an enormous rate gap had developed because his average interest rate had risen to 11 percent while the rate of return to capital had fallen slightly to 3 percent. Furthermore, the growth in real earnings and asset values had reversed, becoming negative.

This development created great new variation in the financial prosperity of individual farmers. A farmer with no debt experienced a return to equity of 3.3 percent in 1982. For farmers with debt and paying the average interest rate of 11 percent, a debt-to-asset ratio of about 30 percent represented the break-even point at which the return to equity was zero. At a debt-asset ratio of 40 percent, the loss was 1.8 percent of equity; at 60 percent, 8.2 percent; at 80 percent, 27.5 percent. For farmers paying interest rates above the sector average of 11 percent, the break-even point was reached at an even lower debt-asset ratio, and the losses at higher debt-to-asset ratios were proportionately greater.

Now since the average return to equity last year was a positive 1.4 percent, it is evident that a majority of farm operators were not in debt positions leading to such depression-like losses. Information on the distribution of farmers by debt-to-asset ratios has recently become available upon the release of results of the 1979 Farm Finance Survey conducted by the Census Bureau.

In table 1, these survey findings have been adjusted and updated to be indicative of conditions at the beginning of this year. The top panel indicates that only about 18 percent of operators have the level of debt—a debt-to-asset ratio above 40 percent—that has likely meant unprofitable operations. That proportion, however, varies from 44 percent of operators of large farms to 11 percent of operators of very small farms.

The second panel shows that, from the perspective of lenders, the picture looks much different. Well over half of the debt is owed by operators with debt-asset ratios over 40 percent, and thus lenders see much of their money in the hands of operators who are experiencing financial difficulties.

The significant minority of farmers whose main financial problem is a relatively heavy debt at a relatively high interest rate is likely to remain in serious difficulty until interest rates they pay fall sufficiently further to close much more of the gap that arose between these rates and the return on assets. The moderate rise in the return to assets now underway, while helpful, is miniscule compared to the rate gap faced by these farmers. Even if the rate of return were to be increased to the 1979 level of 5 percent, that would close only 2 percentage points of the gap that has arisen. The only way to really get the gap closed is to get interest rates down.

The spread this year between the average return to capital and the average interest rate paid on farm debt will probably be almost as large as in 1982. To stop their progressive loss of equity, heavily indebted farmers need a further significant drop in interest rates, which would close the rate gap by reversing the main development that opened it.

Dr. EDELMAN. Thank you, Mr. Melichar.

[The prepared statement of Mr. Melichar follows:]

Farm Profits and Financial Distress

Workshop on Credit and Tax Policies for the Family Farm

Committee on Small Business
United States Senate

April 27, 1983

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Farm Profits and Financial Distress

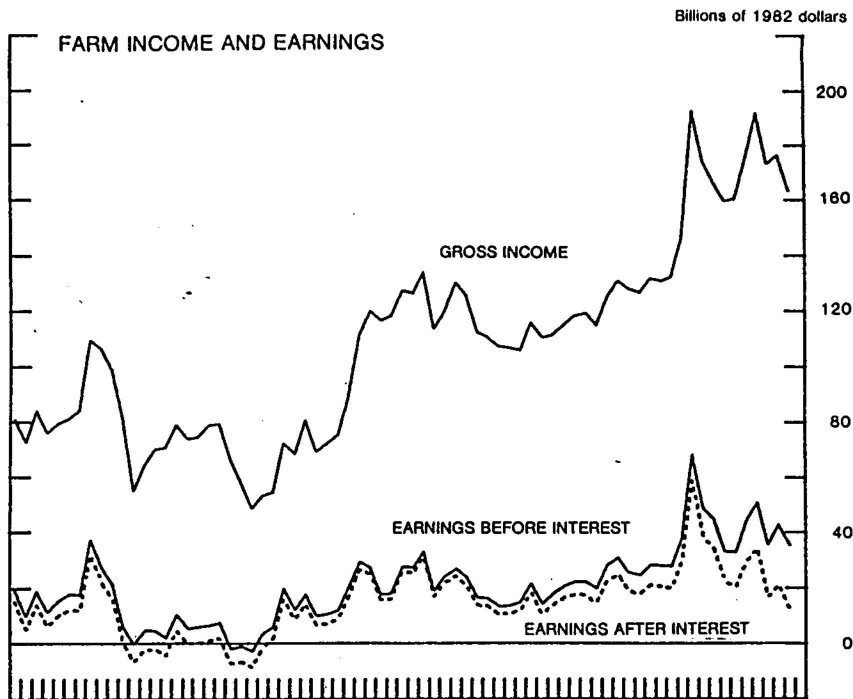
In this statement I endeavor to contribute to understanding of two areas important in the development of farm policy: (1) the profitability of farming, and (2) the nature and incidence of recent severe financial stress on individual farms.

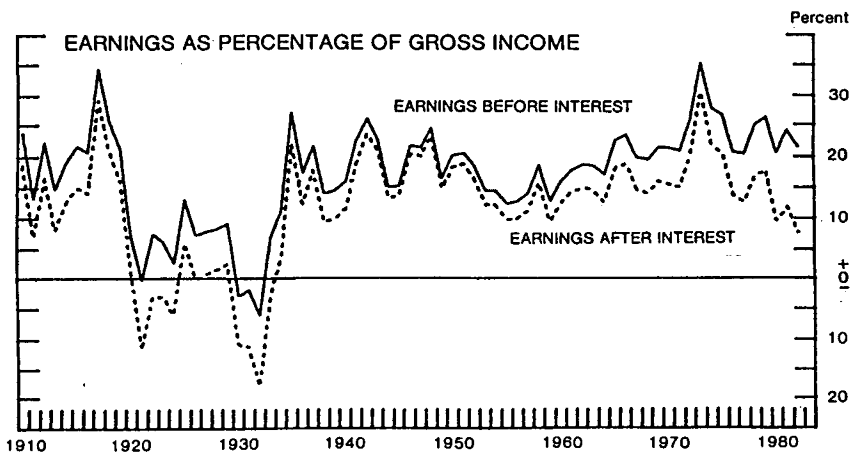
Many discussions of policies toward agriculture and family farms are flawed because the participants hold incorrect impressions of the profitability of farming. It is widely known that a low rate of return to farm capital has prevailed during most years of the past three decades, but relatively few of the many persons--economists, editors, and government officials--who occassionaly comment on farm policy and well-being appear to know that the amount of that return has exhibited a substantial long-term uptrend, or to have thought about the implications of that uptrend for concerns such as the pricing of farm real estate, the problems of beginning farmers, or the trend of food prices.

The trend of farm profitability has been masked because most farm operations are proprietorships, and thus reported income is a combination of rewards to operators' labor, management, and capital. After adjustment for inflation, the long term trend in that total income has been essentially flat. Over time, however, the farm management and labor force consisting of farm operators and their families has been drastically reduced; therefore, given the same real total income, the income attributable to labor and management work has fallen, while that due to capital has risen.

Chart 1 shows estimates of such earnings of capital, calculated in the manner developed by the USDA, which in effect are the income left after "paying" operator and farm family labor at the average farm wage rate, plus a "management fee" equal to 5 percent of gross income. Data are charted in 1982 dollars, using the deflator for personal consumption expenditures as the index of general price inflation. It is evident that the farm programs in effect since the mid-1930s have been successful in maintaining earnings in the aftermath of the farm booms of 1941-52 and 1972-79, in sharp contrast to the collapse of earnings after the boom of World War I. In the last few years, it is also clear that while earnings before interest have been well maintained in the face of adverse supply-demand developments, sharply increased interest payments have produced noticeably lower earnings after interest.

Chart 1





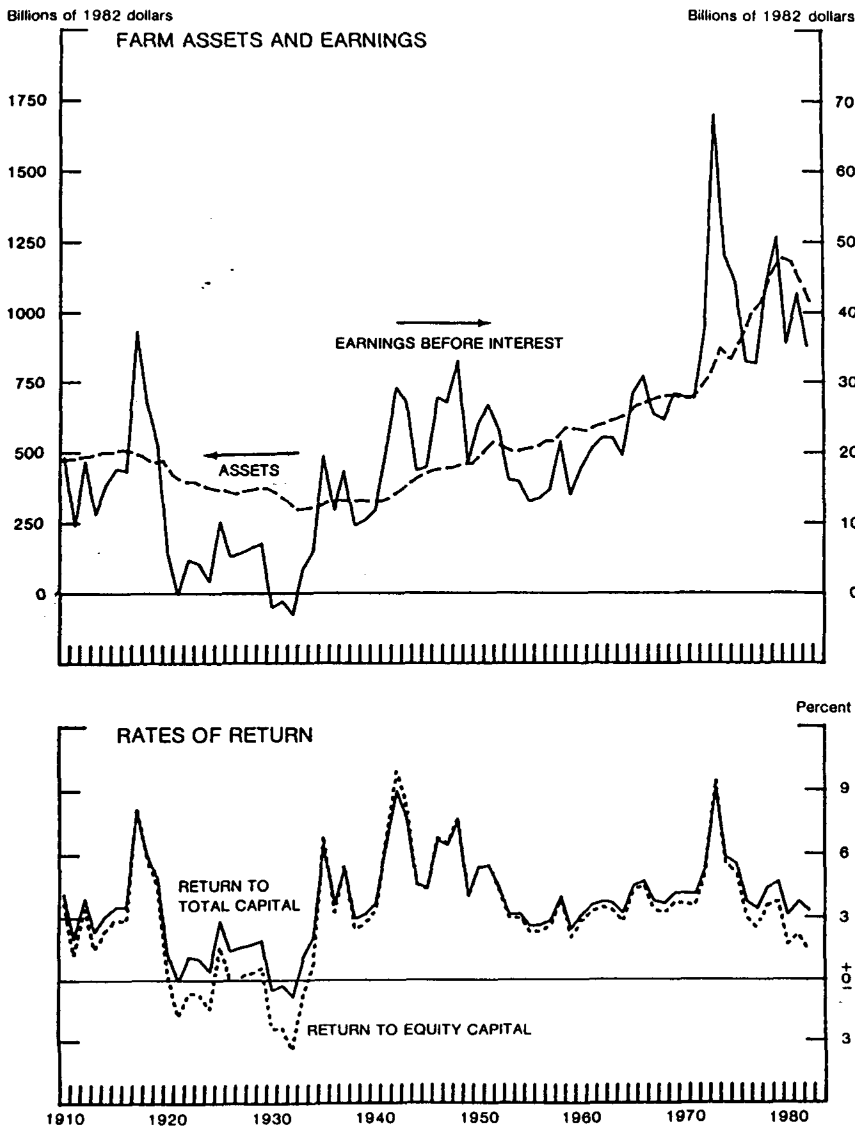
Before exploring this credit development in detail, the relationships between earnings and asset values merit attention. The top panel of Chart 2 shows the long term record of these series, with both adjusted for general price inflation, and with the scale for assets set at 1/25 of the scale for earnings. Therefore, when assets and earnings are at the same level on this chart, it means that assets are then valued at 25 times current earnings, or, alternatively, that the rate of return to total capital is 4 percent. The chart indicates that these have been the approximate average values.

Chart 2 indicates that asset values, dominated by real estate prices, tend to follow the trend in earnings. In addition, expectations of the future trend of earnings appear to play a major role in the reaction of asset prices to ongoing changes in earnings. During the earnings boom associated with World War II, the Marshall Plan, and the Korean War, a postwar collapse in earnings was widely expected, and the rise in asset values was relatively moderate in spite of long-term farm credit being readily available at relatively low real interest rates. In contrast, in the late 1970s, when there was widespread optimism regarding future growth in farm earnings because of fundamentally favorable worldwide supply-demand relationships, asset prices were bid up to a level that can be viewed as consistent with expectations that earnings would continue rising at the relatively steep 1954-79 trend. The ready availability of credit at a favorable real interest rate certainly encouraged its use in farm asset purchases, but the primary impetus to land prices was provided by the earnings growth record and optimistic earnings expectations.

As 1980 began, earnings fell far below the upward trend to which asset prices appeared to be pegged, and as this condition persisted, farm land prices began a retreat in mid-1981. Farm programs again supported earnings, however, and the return to total capital remained above 3 percent. But at the same time, interest rates soared to unexpectedly high levels and remained there through much of 1980-82, with devasting impact on those heavily indebted farmers paying the new rates. This development immediately created immense new variation among farmers in the return to equity, related to the degree of indebtedness and the interest rate being paid.

Take, for example, several farmers who each earned an average return to their total capital, which was 3.3 percent in 1982. For a

Chart 2



farmer with no debt, that was also his return to equity. Suppose next that the other farmers had outstanding debt on which they were paying the sector average rate of 11 percent in 1982. If such a farmer had a debt/asset ratio equal to the sector average of 20 percent, his return to equity was 1.4 percent. At a debt/asset ratio of 40 percent, a loss of 2 percent was experienced; at 60 percent, a loss of 8 percent; at 80 percent, a loss of 28 percent. Proportionately larger losses were suffered by farmers paying higher interest rates, as might especially be the case among operators who, as rates rose, were caught relying primarily on short-term loans.

Since the average return to equity last year was a positive 1.4 percent, it is evident that a majority of farm operators were not in debt positions leading to such Depression-like losses. Information on the distribution of farmers by debt/asset ratios has recently become available upon the release of results of the 1979 Farm Finance Survey conducted by the Census Bureau. In Table 1, these survey findings have been adjusted and updated to be more indicative of current conditions. The top panel indicates that only about 18 percent of operators have the level of debt--a debt/asset ratio above 40 percent--that has likely been associated with unprofitable operations. That proportion, however, varies from 44 percent of operators of large farms to 11 percent of operators of very small farms.

From the perspective of lenders, the picture looks much different. Well over half of the debt is owed by operators with debt/asset ratios over 40 percent, and thus lenders see much of their money in the hands of operators who are experiencing financial difficulties.

The significant minority of farmers whose main financial problem is a relatively heavy debt at a relatively high interest rate is likely to remain in serious difficulty until interest rates they pay fall sufficiently further to close much more of the gap that arose between these rates and the return on assets. The moderate rise in earnings now under way, while helpful, is miniscule compared to the rate gap faced by these farmers. The spread this year between the average return to capital and the average interest rate paid on farm debt will probably be almost as large as in 1982. To stop their progressive loss of equity, these farmers need a further significant drop in interest rates, which would close the rate gap by reversing the main development that opened it.

Table 1. Estimated distribution of farms by relative debt level within farm-size groups, January 1, 1983

Size of farm (annual sales, $000)	Relative debt level of farm operator (debt/asset ratio, percent)					Percentage distribution in classes with debt/asset ratio over 40 percent, by farm-size groups
	Total	0-10	11-40	41-70	71 and over	
	Percentage distribution of operators					Operators
All farm operators.............	100	58	24	11	7	100
Large farms (200 and over)....	100	20	36	25	19	10
Medium farms (40 to 199)......	100	34	35	18	13	39
Small farms (10 to 39)........	100	55	26	11	8	23
Very small farms (under 10)...	100	73	16	7	4	29
	Percentage distribution of debt					Debt
All farm operators.............	100	5	32	32	31	100
Large farms (200 and over)....	100	3	26	33	38	40
Medium farms (40 to 199)......	100	5	34	33	29	42
Small farms (10 to 39)........	100	7	37	29	26	10
Very small farms (under 10)...	100	8	37	32	23	8
	Percentage distribution of assets					Assets
All farm operators.............	100	47	31	14	8	100
Large farms (200 and over)....	100	26	38	22	14	38
Medium farms (40 to 199)......	100	38	37	16	8	43
Small farms (10 to 39)........	100	61	26	8	4	10
Very small farms (under 10)...	100	73	18	6	3	9

Data from the 1979 Farm Finance Survey, Bureau of the Census, as tabulated by ERS, USDA, and (a) adjusted for probable underreporting on the survey date and (b) updated to reflect changes during 1980-82, including increases in total debt and assets, an increase in the number of indebted operators, and liquidation by some operators with high debt/asset ratios. A description of the adjustment and updating will be available from the author.

<u>References on Farm Earnings, Asset Values, and Financial Stress</u>

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Statement on the farm income situation, <u>State of the Farm Economy</u>, Hearing before the Committee on Agriculture, House of Representatives, 97th Congress, 2nd Session, September 28, 1982.

"Toward Understanding the Financial Situation in Agriculture," draft circulated April 7, 1983.

Copies of the above papers are available from the author upon request.

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Dr. EDELMAN. We will now enter the second discussion period. The floor is now open for questions from participants first.

Do any of the participants have any questions that they would like to raise at this time?

Mr. MELICHAR. Are comments appropriate?

Dr. EDELMAN. Comments would be appropriate, provided they are short.

Mr. MELICHAR. I was struck by use of the term "lender of last resort" to describe the Farmers Home Administration, because in the banking business that refers to a rescue operation, with the Federal Reserve being the lender of last resort to banks.

Most of the speakers who used that term appeared to want the Farmers Home Administration go back to its original function of providing development and supervised credit, rather than providing rescue loans to established farmers who had somehow gotten into financial trouble. The data I presented show that large farmers are more likely to have been experiencing financial stress.

For bankers, the term "lender of last resort" brings to mind assistance from the Federal Reserve to even large banks that get into trouble because of problem loans, which may lead their depositors to withdraw their funds.

Perhaps an analogy exists with the international lending organizations. The World Bank makes development loans to countries at reasonably low interest rates, whereas the IMF is the lender of last resort to a country in financial trouble. Persons who want the Farmers Home Administration to be more like the World Bank rather than the IMF may want to get away from using that term.

Dr. EDELMAN. A response, Mr. Blobaum, or an additional question?

Mr. BLOBAUM. I think it is in the nature of a response.

When you look at most of the legislation passed by Congress dealing with agriculture, you have preambles that point out support for the family farm, dispersed agriculture, and so forth. If we are going to abandon the idea of lender of last resort, then we ought to get it out on the table and debate it as a matter of policy and determine whether or not that is what Congress wants to do and that is what people in agriculture want to do.

One of the problems with this whole area is that there are a lot of decisions made that are never really publicly debated. That is one of the reasons I made the comments on rulemaking, and I think there are some other areas in this whole farm credit picture that really ought to be out because they are policy questions. They are not implementation of statute questions. They ought to be brought out and fully debated.

If the American public does not want Farmers Home to be the lender of last resort, then we ought to go through that process. Otherwise, we should be the lender of last resort, as the statute points out.

Dr. EDELMAN. Additional questions from the panel?

Mr. PATNOE. One short comment.

Dr. EDELMAN. OK, Mr. Patnoe.

Mr. PATNOE. As late as yesterday morning, I talked to a county Farm Home administrator, and he said, "I hope you will remember that we don't choose our clientele."

Dr. EDELMAN. Thank you.

Mr. MELICHAR. I would like to address a question to Mr. Blobaum.

There has been much concern about the $600 million in economic emergency authority that was not used. Now $6 billion of economic emergency loans were made, starting in August 1978, and mostly put out during 1979, which was a very good farm income year. Apparently, these loans went to farmers who were in trouble almost immediately when farm output prices fell from their peak levels. They are the farmers who are now delinquent, in very high percentages, at the Farmers Home Administration.

The rescue-loan approach has a number of flaws. How, for instance, do you separate out the farmers who have made an uneconomic investment, such as putting up a center pivot irrigation system in western Nebraska to grow wheat on former grazing land, that requires $5 or $6 wheat to pay off? Do you keep giving that farmer economic emergency loans for 20 or 30 years, while he struggles to repay that one mistake? Isn't it kinder to recognize an investment that appears unlikely to pay for itself, and allow the loss to be shared quickly by the lender and borrower? The borrower hopefully will be able to start over, perhaps the sooner the better.

Mr. BLOBAUM. I certainly would not want to be put in the position of defending the people who have developed agricultural land on that fragile sand in western Nebraska at the prices that they have paid for the investment, as you point out, in irrigation equipment.

However, I think one of the problems here in looking at credit and agriculture is that we tend to look at a farming operation like we look at a household with an annual budget. If you have a little debt problem at the end of the year, somebody wants to move in. We should have some way to look at agriculture more like you would look at a business, so that you would look at what the 5-year prospects are, because you have so many ups and downs. Why move against a small business, a farm, in the worst year at the worst possible time just because there is a liquidity crisis? Why not move only in terms of, say, a 5-year average of how that farm has done.

So many of the things that happen to farmers are not of their own making. Sometimes they borrow for something that is not a good investment, and that is partly the problem of the lender, but for the most part the things that are causing the difficulty in agriculture today are not caused by the farmers and they are out of their control. All of us as a society have a responsibility to address this problem.

We are involved in a global economy. We were involved in inflation and the policies that brought about high interest rates over a long period of time, the attempt to cure this. These are not problems that were brought on by farmers. These are problems of our entire economy and our entire society.

I think to move in, particularly against young and beginning farmers, in 1 bad year or 2 bad years is bad national policy. I do not think Congress should allow that to happen. They should do something to alleviate that.

Dr. EDELMAN. Are there additional questions from the panel?

[No response.]

Dr. EDELMAN. Are there questions from the audience?

Senator PRESSLER. I would like to say, first of all, that I think all the statements have been excellent. I want to thank the witnesses including those who have departed, because I think they have been very interesting and helpful. I want to thank them for taking the time to participate.

This committee devotes considerable time to a variety of small business subjects, and I wanted them to spend some time on family farm problems as well.

The comment was made that in the old days, checks from farmers using FmHA loan funds were countersigned. That is something that intrigued me. I did not know that.

I find, in looking back at some of the people who are in trouble with FmHA, sometimes you find that a farmer has changed his operation without telling the FmHA or he has purchased equipment that really wasn't envisaged.

I do not know how bureaucratic it would be to reinstitute some of the old methods, but I wonder if maybe we should reinstitute some of those safeguards. Maybe the FmHA would claim that they do not have enough personnel or that it would take too much bureaucratic paperwork, although countersigning checks is not too difficult a thing.

How could we reinstitute some of those controls, so to speak, and should we? I think that is a fascinating question for Congress to think about and for the Administrator.

Mr. Patnoe, you have had a lot of experience in this area. Are there other areas where procedures have loosened up?

Mr. PATNOE. Well, I was appalled that the financial institutions, the local banks, were as lenient as they are. Visiting with one, he said a farmer will come in and say, "I want to buy a new pickup, a new car, or a new tractor perhaps, rather than a car." They will look over his financial statement and say, well, possibly we shouldn't do it right now. He said a week later you will see the man driving up the street in a new pickup. He traded off the one that had the security on it. Technically, they could take him to court and recover their pickup that they had mortgaged. That apparently is not being done. I am really appalled. I thought banks were more strict than this.

Visiting with my own banker, whom I have known for a long time, Mel Hamre—maybe you know him from Clark— he said that it is our own fault, "We made loans where we shouldn't have, figuring FmHA would take it over," and this sort of thing.

However, getting back to the FmHA, countersigning checks is not a big problem. A man goes in with his check and his bill from the elevator or the feed and seed company. He takes it into the secretary. That is all it takes. She checks up in his file. He has $5,000 allocated for fuel. She takes off a thousand dollars off his fuel. It is not hard to do.

Most borrowers are not in that trouble, but the few who are could need more supervision.

I think it has been brought up today that we should have more experts that know something about—not experts; we have experts that go to college to learn the financial whiz of being a county ad-

ministrator, but we need a man that has farmed possibly to go out—and just his presence, making a visit on the farm, the farmer will be more alert and do a better job, keep his yards cleaned up, and just be a better farmer for having more visits. It does not hurt to have a little public relations there, too, to go out and visit and have coffee. I think they would welcome that.

I guess that is about the only thing I could add.

Senator PRESSLER. I have another question regarding the Federal Reserve.

In recent months the prime interest rate has declined substantially but interest rates that farmers pay at local banks have remained high, at least in my State. What is the reason for this? What can be done to bring those local rates down?

Mr. MELICHAR. We have some surveys conducted of the rates at rural banks. Right now the farm loan average is in the 13 to 14 percent area, which is above the prime rate. It is pretty clearly established that agricultural banks, the smaller banks, charge an interest rate to their borrowers based on a markup over their average cost of funds.

There is convincing evidence of this in earlier monetary and business cycles, such as, for instance, the 1969–70 cycle, or particularly the 1973–74 cycle, when the cost of funds at these small banks increased very little while national level of interest rates went to very high levels.

For instance, in 1974 the prime rate reached 12 percent. But because the cost of funds to the small agricultural lending banks rose very little, the interest rate they were charging to borrowers was in the 8 percent area, even though the prime rate was 12 percent. They were simply pricing loans according to their cost of funds, which stayed low because there was still an interest-rate ceiling on time deposits, and demand deposits were not earning interest at that time.

Now it is clear that small banks have continued to behave in that way, but starting in 1979 the first big change was that the depositors shifted their funds from passbook deposits into 6-month money-market certificates which paid a rate related to national market rates. At that time, then, the loan rates charged at the country banks started to move as roughly a 26-week moving average of that money-market certificate rate, plus the markup. In fact, there were economists who as that development got under way, worried whether agricultural and similar bankers would realize how their cost of funds was rising and raise their loan rates quickly to keep their banks out of trouble. However, those fears proved unjustified. The bankers were apparently quite aware of what they were paying and, with the sign in the window saying that they were paying 14 percent for 6-month money, I believe there was probably no problem in telling the borrower, "Well, you are going to have to pay 17 percent."

We find that loan rates at these smaller banks rose into the 17 to 18 percent area when they were paying from 14 to 15 percent on these 6-month certificates. At the peak last year, the 6-month certificates accounted for 30 percent of the toal assets, on average, at agricultural banks. Therefore, it is quite understandable that the

cost of this money would be most important in setting the loan rate.

The rates paid on these deposits have dropped now to the 8.5 percent area. But for the banks, there was a 6-month lag before all of the certificates issued at higher rates came due and were renewed at 8.5 percent or so.

Also, additional money has been put into money market deposit accounts, newly authorized in December, on which bankers are planning to pay 8 to 9, some as high as 10 percent.

As I calculate it, there is room for farm loan rates to come down some more, and perhaps they are coming down. The data that we collect on loans lags a couple of months.

It has only been during the past couple of months that the average cost of funds to these rural banks has fallen into the 8.5 to 9 percent area. Putting a typical markup on that should get the farm loan rate down into the 12 to 13 percent area, rather than the 13 to 14 percent area where it was at our last survey. However, that is about as low as it can go, around 12 percent, if banks are continuing to pay roughly 8.5 percent.

To give further relief to borrowers, the overall level of rates has to decline. It is unsustainably high relative to the current inflation rate.

Senator PRESSLER. Ms. Lerza, what becomes of the black farmers who leave the farm? Do most of them go into the urban centers? Do they go on unemployment? Do they work for other farmers? Has there been any tracing done?

Ms. LERZA. Probably no more than there has been for white farmers once they are forced to leave the farm. Historically, if you look at trends since 1920, blacks did go to Northern cities after they left farms in the South. I am not sure why anyone today could choose to go to a Northern city right now to find a job, since there are none. Probably those people do end up, since they have lost everything they have worked for, trying to find a job in their community. Most of them are people who prefer to find a job in their rural community or at least in their region. If not, ending up on welfare rolls.

Senator PRESSLER. I have one final question for Mr. Patnoe.

What do you hear at the grassroots in terms of people's confidence in the Government to get these loans to the family farmers instead of being siphoned off by some of the bigger semicorporate farms?

Mr. PATNOE. It is funny you should mention that. Yesterday when I was getting ready to go, two farmers drove into the yard. I told them where I was going, and this one fellow—you might say he is a little bit outspoken—he said, "Well, I've got a boy who is trying to borrow $40,000 to get a milking barn set up." He said, "What about this so and so up town here? He has built $150,000 house out in the Black Hills and then had to be refinanced by the Farmers Home Administration, and he got his loan?"

Earlier you stated this, and I hear it quite often, really.

I had a question of Mr. Melichar.

Do I understand you right? The highest that the farmers paid a year and a half ago was—what did you say 18 percent?

Mr. MELICHAR. The average interest rate at the smaller banks rose to about 18 percent, and there were very few borrowers at small banks paying over 20 percent when loan rates peaked.

At large banks the prime rate went to a high of 21.5 percent. At large banks there were quite a few farm borrowers paying over 20 percent at that time, some over 25 percent. These were mainly farmers in States where there are large branch banks—California and other western States, and the East and Southeast. Of course, in your area you have mostly smaller banks.

Mr. PATNOE. They paid as high as 22 at small banks in my area. What hurt them, they had to pay every 90 days. This took their operating money away and really killed them. The banks used to pay 6 months or a year. Ninety days and you come in and pay the interest.

Right now it is 14 to 15.5 percent to the best borrowers in our area.

Mr. MELICHAR. There were cases of the kind you cite found in our survey, but they were the exception. Terms of some loans did shorten, but the typical farm loan maturity remained in the 6 to 9 month area. The average came down from about 8 months to 6 months. So, there were some of those very short loans where some bankers were protecting themselves both on rate and risk.

There were some loans at small banks with interest rates over 20 percent. They were relatively few. I have complete percentage distributions that I can make available, if you are interested.

Mr. PATNOE. These are the same fellows that are zero equity now and facing bankruptcy. These are the ones that were in trouble at that time.

Mr. MELICHAR. Farmers and most other businesses were unable to earn a profit equal to the interest rate being paid, and it brought on a severe recession.

But at the same time one knew that these high interest rates could not possibly persist because of the effect that they were having on economic activity.

There is one other factor affecting interest rates now being charged by small banks that I should have mentioned in response to Senator Pressler's earlier question. For many years the loan loss rate on loans at agricultural banks was about 0.20 percent. In 1980, as one might expect, it started to rise, reaching about 0.35 percent in 1980, about 0.50 percent in 1981, and about 0.70 percent in 1982. These are loan losses actually reported during those years on the income statements of these agricultural banks.

Losses have thus reached a level that adds nearly 1 percentage point to the interest rate on loans. Banks have to pass that along to borrowers in general.

Dr. EDELMAN. Thank you, Mr. Melichar.

A question, Mr. Severens?

Mr. SEVERENS. Yes. Mr. Melichar, do you have any impressions or possibly any data that indicates what the present-day loan volume of country banks for operating credit is and how it would compare to the same point in time last year? I am not interested in the interest rate; I am interested in the loan volume.

Mr. MELICHAR. Last year the farm loans outstanding at banks rose by 10 percent, whereas at PCA's, they fell by 5 percent.

Mr. SEVERENS. That is comparing——

Mr. MELICHAR. The previous 2 years farm loans grew by very little at banks and by more at PCA's. Then loan demand at banks recovered.

The agricultural banks in the fall of 1979 reached a loan-deposit ratio or liquidity position where they were very tight. They were concerned about their ability to make loans in the coming spring, particularly in the upper Midwest area. The banks there had reached average loan-deposit ratios in the 70 percent area, far above the norm prior to 1976, when the upturn in loan-deposit ratios began.

Then in the spring of 1980 a very drastic turnaround occurred. You may recall the credit controls that were instituted by President Carter in March of 1980. Loan demand dropped among most borrowers. This was particularly true of farmers, because their income also happened to drop at the same time.

Loan demand was much reduced. From that point on, deposits at the agricultural banks have risen much faster than loans. Deposit growth was about 10 percent a year through all these years. Loan growth was much below that in 1980 and 1981, and then in 1982 was about equal to deposit growth. Thus, the average loan-deposit ratio at agricultural banks has fallen from 68 percent in the fall of 1979 to the present level of about 58 percent, and most banks are reporting that they are quite eager to make more loans.

Given the interest rates that prevailed over this period and given farm income prospects, it is not at all surprising that the farm loan demand was not there.

Mr. SEVERENS. Is there any justification for a hypothesis that, because of the increase in loan losses that you were just describing earlier among the country banks that began in the eighties, that many of these country banks are discouraged from making or more cautious in making agricultural loans and, as a result, are making fewer of them?

Mr. MELICHAR. I would say that they have been more cautious, if they were at all alert as to what was going on in farm income. I think it is safe to say that most were more cautious, more careful, demanding greater collateral, watching the marginal loan, and so on. They also had interest rate gyrations to cope with, the same as the borrowers did.

At the same time, they have to put the money to work in order to pay the depositors, in order to earn money for the bank.

Mr. SEVERENS. I was wondering if they were putting the money to work some place else.

Mr. MELICHAR. In 1982, as I indicated, the farm loan total went up by 10 percent, and the increase was widely distributed around the country. It was greatest in the ninth district, the Minneapolis district, which includes the Dakotas, where farm loan volume was up 15 percent last year. I think there definitely was a shift from production credit associations to banks, as the banks got more competitive on loan rates and maybe the PCA's got even more cautious than the bankers.

Dr. EDELMAN. Are there further questions from panel members or from the audience?

[No response.]