

SEASONAL DISCOUNT ASSISTANCE TO RURAL BANKS:

EVALUATION OF A FEDERAL RESERVE PROPOSAL

Emanuel Melichar
Board of Governors of the Federal Reserve System

Reprinted from the Agricultural Finance Review, U. S.
Department of Agriculture, Volume 30, July 1969

Seasonal Discount Assistance to Rural Banks: Evaluation of a Federal Reserve Proposal

By Emanuel Melichar ^{1/}

Every spring, when farmers withdraw deposits and obtain loans to finance crop production, many rural banks experience a heavy outflow of funds. At harvesttime, when the money returns, rural bankers have little choice but to store funds over the winter as cash, deposits in other banks, or temporary investments in U.S. Treasury bills and other very liquid securities. They know that seasonal demands will reappear next spring. In effect, the funds are productively employed in the local community for only about half a year.

A few years back, when most banks had ample assets above loan demands, this consequence of seasonality caused little concern. But now many rural banks are hard pressed to meet all credit demands upon them. The large seasonal outflows probably reduce their ability to meet either seasonal or year-round credit demands. Can these banks be provided with an absolutely assured outside source of seasonal funds to meet vital farm production needs, so that they can employ their own resources more efficiently in year-round community lending?

A committee of Federal Reserve governors and Federal Reserve bank presidents thinks so. In a recent report, it recommended that some member banks be allowed to make advance arrangements to finance the bulk of their seasonal fund outflow by borrowing at the discount window of their Federal Reserve bank.^{2/} Under the conditions proposed for such borrowing, smaller rural banks would supposedly predominate among banks eligible for such assistance. This recommendation, along with others emanating from an intensive study of the Federal Reserve discount mechanism, was announced in July 1968, at which time comments were invited from the financial community and the public. After incorporation of revisions concerning these comments and further Federal Reserve research, adoption of these proposals is likely.

The agricultural finance community has an obvious interest in a proposal that promises to improve the farm-lending capability of commercial banks. It might well ask about the factors that led the Federal Reserve System committee to this recommendation and about the results that may be expected. How many rural banks may benefit? What will the privilege mean to these banks? And will it have a significant impact on the ability of the banking system to finance farmers? This article attempts to answer some of these questions.

^{1/} Economist, Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, D.C. Views expressed are those of the author and do not necessarily concur with those of other research staff members or with those of the Board of Governors.

^{2/} Board of Governors of the Federal Reserve System, Reappraisal of the Federal Reserve Discount Mechanism: Report of a System Committee, Washington, D.C., July 1968.

Framework for Consideration, Design, and Evaluation

The System committee summarized its concern for the future availability of bank credit in rural areas as follows:

With the passage of time ...liquidity positions of banks in many of the smaller communities... have been markedly reduced by expanding seasonal and secular demands for credit on the one hand and lagging community net income and deposit growth on the other. Particularly in agricultural areas, where credit needs have been rising very rapidly, such trends seem likely to continue, progressively narrowing the ability of the local banks to meet the short-term credit demands in their communities.

Further, the committee believed that reduced credit availability was aggravated by seasonal fluctuations in loans and deposits which "tend to be the greatest in smaller communities where the economy is frequently dominated by agriculture or by a single industry of relatively small units." Banks might meet both general credit deficits and seasonal fluctuations by tapping national or international money markets, but the committee noted that "Because of size, structure, and location, banks in small towns are often at a relative disadvantage in obtaining credit from other external sources."^{3/} Some funds are obtained from correspondent banks, but small bank participation in other national capital markets is limited.^{4/}

In this context, the committee first considered whether the discount mechanism might be used to provide long-term credit to meet the needs of banks servicing perennial credit-deficit areas or sectors. This role, the committee concluded, would not be a desirable one for the discount window at present, as it "would enmesh the System in socio-economic and political problems beyond its proper scope," while exposing rural banks to the hazards of "financing the expansion of loan portfolios far beyond the limits of deposits." Instead, the committee indicated that "more direct and fundamental answers to the credit-deficit problem ...lie in the improvement of secondary markets for bank assets and liabilities."^{5/} We will return to this point later.

While rejecting the provision of general long-term credit assistance through the discount window, the committee acted favorably on the provision of credit to meet seasonal loan demands and deposit withdrawals. It is evident, however, that the two problems and proposals are related. Seasonal fluctuations have become a significant problem only because overall credit demands strain rural bank resources.

These factors constitute the framework within which the seasonal borrowing privilege was considered and designed, and provide the context within which its impact should be evaluated. Evidence on both

^{3/} Ibid., pp. 13-14.

^{4/} Disadvantages faced by small rural banks are discussed by Bernard Shull in Reappraisal of the Federal Reserve Discount Mechanism: Report on Research Undertaken in Connection With a System Study, Board of Governors of the Federal Reserve System, Washington, D.C., pp. 22-35, August 1968.

^{5/} Reappraisal of the Federal Reserve Discount Mechanism: Report of a System Committee, op. cit., p. 22.

the general liquidity position and the seasonal fund outflows of rural banks is relevant to the desirability of the borrowing privilege. In evaluating the potential impact of this privilege on farm credit availability, we must consider that it can alleviate credit demand pressures only at certain member banks. We will be interested in the liquidity position of these banks and in their share of total bank lending to farmers.

Considerations in Support of a Seasonal Borrowing Privilege

Some of the primary considerations supporting the proposed seasonal discount privilege are (1) reduced liquidity of many rural banks, (2) apparent failure of seasonal farm lending by banks to expand as rapidly as farmers' seasonal needs, (3) the way large seasonal outflows impair a "tight" bank's ability to meet community credit needs, and (4) the prevalence of such outflows among the banks financing agriculture.

Lending Capability of Rural Banks Has Been Impaired

Since the end of World War II, farmers have continuously increased the amount of credit they employ. Commercial banks have contributed to meeting the increase in farm credit demands at about the same rate as all lenders together. During the decade ended 1967, for instance, farm loans outstanding at banks rose by 156 percent, while total farm debt increased by 147 percent.

Farm credit supplied by banks, however, expanded much faster than rural banking resources. During the same decade, for example, deposits at country banks in 20 farm States rose by 82 percent, according to USDA estimates. As seems logical, the rise in rural bank deposits more closely paralleled the gains of 49 percent in farm cash receipts, 62 percent in nonfarm income of the farm population, and 59 percent in the value of farm assets.

Banks have been able to increase loans faster than deposits since World War II because they entered this period with very low loan-deposit ratios. During the war, high farm incomes and reduced availability of goods enabled farmers to repay debts and build up bank accounts. Thus banks had ample funds invested in securities which could be sold as greater loan demand materialized. But as this process continued for many years, some banks began to exhaust their store of liquidity.

In the 1960's, significant numbers of rural banks reached liquidity positions tight enough to influence their lending policies. A sample survey representing over 9,000 banks active in farm lending has shown that the proportion of these banks with loan-deposit ratios of 60 percent or higher rose from 25 percent in 1962 to 46 percent in 1967.^{6/} A Federal Reserve survey of farm lending in June 1966 indicated that banks began to experience significantly increased difficulty in financing their farm borrowers when loan-deposit ratios reached this level. Whereas 12 percent of all agricultural banks reported

^{6/} Agricultural Committee, The American Bankers Association, Agricultural Banking Developments, 1962-1967, p. 8.

farm financing difficulty during the year preceding the survey, difficulty was reported by 26 percent of the banks with loan-deposit ratios of 60 percent and above.^{7/}

Seasonal Farm Lending by Banks Has Been Impaired

Any attempt to determine with precision how well seasonal credit extensions have been meeting the seasonal financial needs of farmers will be thwarted by insufficient data. Seasonality of farm expenses has not been measured, though estimated annual totals are available. Similarly, seasonal credit extensions by lenders other than Production Credit Associations (PCA's) are largely unknown--most banks report outstanding volume of farm loans twice a year (December 31 and June 30 in most years) and only scattered data are available on lending by dealers and individuals.

Nevertheless, some relevant evidence can be gleaned from these data. For instance, annual expenditures for current farm operating expenses that clearly have a significant seasonal component--purchases of seed, fertilizer, and lime; operation and repair of motor vehicles and machinery; and wages and perquisites of nonresident hired workers--increased at an average annual rate of 3.2 percent between 1955-57 and 1965-67. If the degree of seasonality of these expenses remained roughly unchanged over this period, the amount of the seasonal spending also rose at about the same rate.

On the credit extension side of the puzzle, the January-July variation in loans outstanding at PCA's and banks, after adjustment for trend, can serve as an index of seasonal credit extensions by these lenders. This is under the assumption that a change in the amount of seasonal lending would change the difference between January and July outstandings by about the same proportion. Over the same period used for expenses, the semiannual variation in total PCA and bank non-real estate loans to farmers rose at an average annual rate of 3.8 percent, or somewhat faster than the estimated amount of seasonal expenses. One might thus reason that these institutional lenders have responded to the increased seasonal credit demands arising from larger seasonal expenses.

However, the increased seasonal credit demands appear to have been met mainly by PCA's rather than banks. The amount of the semiannual variation in non-real estate loans at banks rose at an average yearly rate of only 1.7 percent, whereas that at PCA's rose by 6.3 percent annually (table 1). These data support the belief that the ability of banks to expand seasonal lending has been impaired in recent years.

Large Seasonal Outflows Impair a Bank's Overall Credit Services

Bank reports as of December 31 and June 30 of each year reveal that many banks, including those in farming areas, experience deposit outflows during the first half of the year and deposit inflows

^{7/} Emanuel Melichar, "Bank Financing of Agriculture," Federal Reserve Bulletin, pp. 931-932, June 1967.

Table 1.--Semiannual variation in bank and Production Credit Association non-real estate loans to farmers, 1955-67

Year	Amount by which July debt exceeded average of debt at beginning and end of year	
	All banks	PCA's
	-----Million dollars-----	
1955.....	385	185
1956.....	363	183
1957.....	222	161
1958.....	255	178
1959.....	336	262
1960.....	329	241
1961.....	311	244
1962.....	278	243
1963.....	425	313
1964.....	500	324
1965.....	326	299
1966.....	385	324
1967.....	433	356

during the second half. Furthermore, many smaller banks, particularly those heavily involved in financing agriculture, also experience an increase in loans during the first half of the year and in repayments during the second half. Thus many banks financing farmers, especially in crop production areas, experience a heavy outflow of funds through a simultaneous withdrawal of deposits and increase in loans during the spring. In the fall, the funds return as deposits and loan repayments.

Appreciation of the intensity of such seasonal flows is perhaps best attained by examining actual data from banks exposed to the more extreme conditions. Data for three small rural banks in Nebraska were combined to show the "average" experience of the "composite" bank (table 2). Banks with relatively, but not uncommonly, large seasonal flows were purposely selected for this example.

On both the December and June reporting dates, more than three-fourths of the loans outstanding at the composite bank were farm loans. But farm loans increased 64 percent between December 1965 and June 1966. In the same interval, deposits of individuals, partnerships, and corporations (IPC deposits) decreased by 17 percent. Even after adjustment for an upward growth trend in deposits and loans, the combined semiannual fund outflow from increases in loans and withdrawal of IPC deposits equaled 48 percent of the December level of total deposits.

As the composite bank received deposits in the second half of the year, the money was used primarily for purchasing U.S. Government securities, and some funds were held as balances at other banks (table 2). In the spring, deposits flowed out of the community and farmers

Table 2.--Semiannual fund flows at a composite rural bank in Nebraska,
1965-66 1/

Item	Amount outstanding			Trend-adjusted December-June change as a percentage of total deposits in December
	June 30, 1965	Dec. 30, 1965	June 30, 1966	
	-----Thousand dollars-----			-----Percent-----
Farm loans.....	1,867	1,295	2,124	+22
Loans <u>2/</u>	2,414	1,664	2,485	+25
Deposits (IPC).....	2,684	3,549	2,952	-23
Balance at other banks....	324	555	398	-6
U.S. Government securities:	687	1,847	611	-38
Loans as a percentage of total deposits.....	77.8	40.4	74.9	---

1/ Average for three selected rural banks in Nebraska.

2/ Total gross loans less loans to financial institutions and loans for purchasing or carrying securities.

borrowed for production purposes. To accommodate these seasonal demands, the composite bank sold securities that had been purchased the preceding fall, and also drew down balances with other banks. The combined trend-adjusted semiannual change in these two assets totaled 44 percent of total December deposits, almost equaling the relative semiannual outflow of 48 percent.

It is evident that the composite bank financed seasonal demands from its own resources, that is from community resources. Funds deposited in the fall were merely stored in anticipation of the outflow expected next spring. The bank had a loan-deposit ratio of 75 percent in June, when its resources were relatively fully employed. In December, however, this ratio was only 40 percent.

The composite bank had nearly a maximum level of nonseasonal loans consistent with meeting seasonal demands from its own resources. If it had additional year-round loan demand, such as for farm machinery and equipment purchases or from consumers and nonfarm businesses, the bank could in theory operate differently and still meet the same seasonal outflow: it could commit its own funds to the additional year-round loans and borrow an equivalent sum during the spring and summer to meet seasonal demands. However, given the present structure of financial markets this would be difficult, perhaps impossible, for a small Nebraskan bank.

On the other hand, if this bank could obtain sufficient funds from a Reserve Bank to cover a significant portion of the seasonal outflow, its year-round lending could increase. Legitimate community needs could be met with assurance that funds would also be available for vital seasonal demands.

It is also possible that this bank, despite the large seasonal outflow, is not meeting the full seasonal loan requirements of its customers. With increasing demand for both year-round and seasonal credit, perhaps seasonal credit is being curtailed. In this event, seasonal borrowing from the Federal Reserve bank would enable the community bank to meet seasonal needs more adequately.

Community benefits from a seasonal borrowing privilege can be expected when banks (1) experience a significant seasonal outflow of funds relative to their size and (2) operate at a relatively loaned-up position at the peak of the seasonal outflow.

Relatively Large Seasonal Outflows Are Prevalent
Among Agricultural Banks

Fund flow data for all member banks, similar to those shown for the composite bank, indicate that banks having at least 25 percent of their total loan volume in loans to farmers are more likely than other banks to have relatively large semiannual fund outflows. (These banks will be referred to as "agricultural banks.") In the 1965-66 period, 26 percent of agricultural member banks experienced a semiannual fund outflow equal to at least one-tenth of deposit volume (table 3). Only 11 percent of other member banks had relative outflow of this magnitude. Also, an additional 32 percent of agricultural banks had semiannual fund outflows equaling 5 to 9 percent of deposits, still a slightly higher proportion than of other banks.

Table 3.--Distribution of member banks by relative semiannual fund outflow and by importance of farm lending, 1965-66

Relative semiannual fund outflow in percent	Total	Farm loans as a percentage of total loans		
		Under 1	1 to 24	25 and over
-----Number-----				
All member banks.....	6,151	1,388	2,713	2,050
Under 5 percent.....	3,398	867	1,665	866
5 to 9 percent.....	1,784	344	786	654
10 percent and over.....	969	177	262	530
-----Percentage distribution by relative outflow-----				
All member banks.....	100	100	100	100
Under 5 percent.....	55	62	61	42
5 to 9 percent.....	29	25	29	32
10 percent and over.....	16	13	10	26
-----Percentage distribution by farm loan ratio-----				
All member banks.....	100	23	44	33
Under 5 percent.....	100	26	49	25
5 to 9 percent.....	100	19	44	37
10 percent and over.....	100	18	27	55

As of June 1966, agricultural banks comprised one-third of all member banks. But of member banks with relative semiannual outflow equal to 10 percent or more of deposits, 55 percent were agricultural banks. Of banks with outflow equaling 5 to 9 percent of deposits, 37 percent were agricultural banks. Thus relatively large seasonal fund outflows were more prevalent among agricultural banks. Many of these were precisely the banks unable to cope with such seasonal flows except by keeping their own resources available for this purpose.

Design of the Seasonal Borrowing Privilege

The System committee intended that the proposed seasonal borrowing privilege "be essentially a small bank provision with the chief purpose of improving the ability of rural unit banks, limited in access to outside sources of credit, to serve communities with relatively narrow and undiversified economic bases."^{8/} This aim would be achieved through the specific rules adopted to govern seasonal borrowing.

Without special attention to these provisions, large urban banks could easily dominate seasonal borrowing. When semiannual fund flows during 1965-66 were calculated for all member banks in the same manner as for the composite bank in the earlier example, banks with deposits of \$100 million or more had 68 percent of the total semiannual outflow, and those with deposits of \$25 million to \$99 million accounted for another 15 percent. Few of these banks had large percentage outflows relative to their deposit volume, but even small relative flows represented a large amount of money. Given the ability of larger banks to obtain funds in financial markets, the committee believed that these seasonal needs could continue to be effectively met through open-market operations.

In line with this sentiment, at least three of the rules proposed by the committee appear to be designed to limit the use of the seasonal borrowing privilege by large banks:^{9/}

- (1) The seasonal need would have to last at least 4 weeks. Thus severe but relatively short outflows that large banks often experience, such as those associated with national holidays or tax dates, would not qualify. Federal Reserve Governor Mitchell has since reported plans to lengthen the minimum duration to 60 days.
- (2) The seasonal outflow would need to arise from "changes in levels of deposits and loans to customers in the bank's market area." Qualifying loans have been further defined as "customer loans arising out of the needs of locally situated borrowers." This provision is intended to "focus the seasonal privilege directly on community banks without ready access to outside sources of funds and subject to large swings in deposits and loan demand keyed to the local economy."

^{8/} George W. Mitchell, "Public Reaction to the Proposed Changes in the Operation of Federal Reserve Discount Facility," remarks at the National Credit Conference of The American Bankers Association, Chicago, p. 15, March 11, 1969.

^{9/} Ibid., pp. 15-16. Also see Reappraisal of the Federal Reserve Discount Mechanism: Report of a System Committee, op. cit., pp. 14-16.

- (3) Borrowing by any bank under the privilege would employ a "deductible" principle, by being limited to the amount exceeding a specified percentage of average total deposits at the bank. The committee indicated that the "deductible" might appropriately be set at from 5 to 10 percent of deposits. Governor Mitchell has more recently reported an intent to set the percentage at the more liberal 5-percent level.

Would the Proposed Privilege Principally Benefit Agricultural Banks?

Using data on semiannual flows, we can roughly estimate the number of banks eligible to borrow and their volume of potential borrowing. Two alternative estimates are made below, one assuming that the deductible amount is set at 5 percent of deposits as the committee now intends and the other at the less liberal 10-percent level.

In table 4, potential borrowings at agricultural member banks are compared with those at other member banks. With a 5-percent deductible, 45 percent of member banks could borrow, and 43 percent of these would be agricultural banks. A 10-percent deductible would limit potential borrowing to 16 percent of member banks, of which 55 percent would be agricultural banks.

Though relatively dominant in numbers, borrowing agricultural banks would tend to be smaller than other banks eligible for the privilege. Thus, with the deductible set at 5 percent, agricultural banks could obtain an estimated 14 percent of total potential seasonal borrowings of \$2,130 million. Under a 10-percent deductible, they could receive 26 percent of total borrowings of \$461 million. But though agricultural banks would get a larger portion of the total credit extended under the latter plan, they would obtain a much smaller sum--only \$120 million compared with \$307 million under the 5-percent deductible.

However, potential borrowings would have more impact on agricultural than on other banks under either plan. This reflects the proportionately greater seasonal outflows at agricultural banks. Under a 5-percent deductible, borrowings could potentially equal 5.3 percent of deposits at eligible agricultural banks, compared with only 2.8 percent at other eligible banks. The 10-percent deductible yields a similar difference in potential impact. These estimates thus indicate that seasonal borrowing arrangements would not only benefit a relatively greater proportion of agricultural banks than of other banks, but would also be of relatively greater importance to eligible agricultural banks than to other eligible banks.

Evaluation of the Impact on Farm Lending

Impact of the seasonal borrowing privilege on farm credit availability can be estimated by comparing potential borrowings with farm loan volume, or by comparing farm loan volume at qualifying banks with total farm loans at all banks. Such estimates are made below, first disregarding the liquidity position of the qualifying banks, and subsequently presuming that lending volume will only be significantly affected at banks in relatively tight liquidity positions.

Table 4.--Estimated maximum seasonal borrowing at agricultural and other banks under alternative discount plans, 1965-66

Item	Total	Farm loans as a percentage of total loans		
		Under 1	1 to 24	25 and over
A. Number of banks eligible:				
With deductible at 10 percent.....	969	177	262	530
With deductible at 5 percent.....	2,753	521	1,048	1,184
B. Distribution of banks eligible (percent):				
With deductible at 10 percent.....	100	18	27	55
With deductible at 5 percent.....	100	19	38	43
C. Borrowings (millions of dollars):				
With deductible at 10 percent.....	461	157	185	120
With deductible at 5 percent.....	2,130	1,022	801	307
D. Distribution of borrowings (percent):				
With deductible at 10 percent.....	100	34	40	26
With deductible at 5 percent.....	100	48	38	14
E. Borrowings as a percentage of deposits at eligible banks:				
With deductible at 10 percent.....	4.1	3.0	4.8	5.5
With deductible at 5 percent.....	3.0	2.6	3.1	5.3
F. Borrowings as a percentage of farm loans at eligible banks:				
With deductible at 10 percent.....	59.4	---	97.0	20.5
With deductible at 5 percent.....	87.3	---	82.4	21.9
G. Farm loans at eligible banks as a percentage of farm loans at all insured banks:				
With deductible at 10 percent.....	7.0	---	4.0	9.9
With deductible at 5 percent.....	22.3	---	20.1	23.8
H. Borrowings as a percentage of farm loans at all insured banks:				
With deductible at 10 percent.....	4.2	---	3.8	2.0
With deductible at 5 percent.....	19.5	---	16.6	5.2

Potential Impact on Farm Lending,
Bank Liquidity Not Considered

Estimated potential borrowings at eligible agricultural banks amount to about one-fifth of present farm loan volume at these banks, under either deductible provision. The seasonal privilege could thus have a significant impact on farm lending at these banks, according to estimates based on the semiannual outflow data.

The impact on farm lending by all commercial banks would be much smaller, but could still be significant, especially with a 5-percent deductible. On the basis of the semiannual data, member banks qualifying for seasonal credit under a 5-percent deductible would have 22 percent of the farm loans outstanding at all insured banks. With a 10-percent deductible the percentage would fall to an estimated 7 percent of outstanding loans.

In a comparison restricted to agricultural banks, the banks qualifying under the alternative deductible plans would hold about 24 percent and 10 percent, respectively, of total farm loan volume at both member and nonmember agricultural banks. Borrowings would be equal to about 5 percent and 2 percent, respectively, of that farm loan volume.

Thus, estimates of the impact on overall farm lending contrast sharply with the much greater impact at the individual banks qualifying for the privilege. The potential impact on total farm lending is restrained because (1) agricultural banks with large seasonal outflows are often small, and (2) two-thirds of all agricultural banks with large seasonal outflows are nonmember banks ineligible for seasonal discount credit.

The data presented may have understated the potential impact of the seasonal privilege however, because they show only the assistance that banks could obtain on seasonal loan demands that have actually been met in the past. Some banks may not have met all seasonal loan demands because of limited funds. After the seasonal borrowing privilege has been operational a few years, seasonal credit patterns in bank statistics could begin to reflect larger underlying demands, which would in turn justify additional discount assistance.

Potential Impact on Farm Lending,
Bank Liquidity Considered

Many agricultural banks that would be eligible for seasonal discount credit appear to have ample loanable funds at present. It is thus doubtful that the privilege alone would lead them to increase their farm lending.

More than one-third of agricultural member banks with relatively large semiannual outflows had loan-deposit ratios under 50 percent even at the seasonal peak (table 5). Some of these banks might still exercise a seasonal borrowing privilege. But liquidity does not appear to be their major problem. Nor is lack of loan demand necessarily responsible for their liquid condition--an analysis by Raymond Doll showed that many such banks do not lack farm lending opportunities in their communities, as many had neighboring banks with much

Table 5.--Distribution of agricultural member banks with fund outflow in January-June 1966, by relative size of outflow and by loan-deposit ratio on June 30, 1966

Relative fund outflow	Total	Loan-deposit ratio (percent)				
		Under 40	40 to 49	50 to 59	60 to 69	70 and over
-----Number-----						
Agricultural member banks, total	1,663	304	376	472	355	156
Under 5 percent	602	118	143	156	125	60
5 to 9 percent	568	102	138	170	116	42
10 percent and over	493	84	95	146	114	54
-----Percentage distribution by loan-deposit ratio-----						
Total	100	18	23	28	21	9
Under 5 percent	100	20	24	26	21	10
5 to 9 percent	100	18	24	30	20	7
10 percent and over	100	17	19	30	23	11

higher loan-deposit ratios.^{10/} To improve their loan service, such bankers apparently need initiative, education, and perhaps deposit competition more than another source of funds.

About 30 percent of qualifying agricultural banks had loan-deposit ratios in the 50-59 percent range. These banks may soon be more seriously concerned with liquidity problems, at which time the seasonal borrowing privilege would constitute a welcome source of funds.

Thus only the remaining 30 percent of qualifying agricultural banks had loan-deposit ratios of 60 percent or higher, the level at which the 1966 Federal Reserve survey indicated that significant numbers of banks experienced difficulty in financing their farm customers. If one assumes that the real impact of the seasonal borrowing privilege would be largely limited to these banks, estimates of its effect on farm lending are considerably reduced. Whereas member banks eligible under a 5-percent deductible provision held 22 percent of all farm loans in the banking system, only 10 percent was at banks that also had the higher loan-deposit ratios. Thus even a relatively liberal discount plan could have only limited overall impact on availability of bank credit to farmers. Under the more restrictive plan, using a deductible of 10 percent, the corresponding proportion is reduced from 7 to 3 percent, and little overall effect could be expected.

^{10/} Raymond J. Doll, "The Changing Structure of Rural Banking," Monthly Review, Federal Reserve Bank of Kansas City, September-October 1966, p. 10.

Summary

Rural member banks facing relatively large seasonal demands can expect significant assistance from the proposed seasonal borrowing privilege. Particularly at those banks with reduced liquidity, discount assistance should improve the availability of farm credit. However, two-thirds of agricultural member banks with loan-deposit ratios of 60 percent and above experience semiannual outflows below 10 percent of deposits, and thus will benefit little from even a liberal seasonal discount policy. The prevalence of nonmember banks in rural areas further restricts the potential impact of such discount assistance on farm credit availability in the banking system.

Thus the proposed seasonal privilege should be regarded as a tool that the Federal Reserve can implement quickly to assist a significant number of rural banks with recurring intermediate-term adjustment problems. But it constitutes only a limited step toward alleviating the pressure of farm loan demands on rural banking resources.

More Help from Improved Marketability of Rural Bank Assets

If rural credit demands continue to outrun growth in deposits, rural banks will need to tap national money markets to maintain their relative role in farm lending.

At present, small rural banks are at a disadvantage in obtaining funds from national capital markets, a fact recognized in the report of the System committee. Secondary markets for conventional mortgages and agricultural paper, which comprise much of the loan portfolio of such banks, were described as "rudimentary or virtually nonexistent." Similarly, concerning purchases of Federal funds (member bank reserve balances), issuance of debentures and marketable certificates of deposit, and purchase of Euro-dollars, the committee noted that "some of the smaller, more isolated banks do not, and in considerable measure cannot, effectively tap these sources of funds."^{11/}

To provide long-term credit to meet the needs of banks servicing perennial credit-deficit areas or sectors, the committee would seek "improvement of secondary markets for bank assets and liabilities." Specifically, an ancillary recommendation advised the Federal Reserve System "to pursue detailed studies of the feasibility of providing long-term credit assistance through some types of market-perfecting actions."^{12/}

Given the expressed reluctance of the Federal Reserve System to undertake direct long-term rediscounting of agricultural notes, the most significant and widespread improvement in the availability of bank credit to agriculture might be obtained through development of a secondary market in agricultural notes, or in debentures secured by such notes. This market, if adequately perfected, would place small, rural banks--and their customers--on a more equal footing with larger,

^{11/} Reappraisal of the Federal Reserve Discount Mechanism: Report of a System Committee, op. cit., p. 6.

^{12/} Ibid., pp. 22-23.

urban institutions in tapping national capital markets for developmental credit. It would also improve the competitive position of rural banks with other farm lenders, including national farm supply corporations and Production Credit Associations.

A desirable longrun approach would also encourage rural banks to become larger institutions and thereby better able to tap national money markets as well as to finance large modern farms. However, this course requires legislative action in many agricultural States to liberalize or remove present restrictions on branch banking.^{13/} The Federal Reserve System could probably effect a more prompt and pervasive improvement in farm credit availability at rural banks by assisting and supporting development of a mechanism that permits rural banks to market their assets.

^{13/} For an expression of this view, see Andrew F. Brimmer, "Central Banking and the Availability of Agricultural Credit," American Journal of Agricultural Economics, May 1968, pp. 357-365. In this article, Governor Brimmer also cites the desirability of improving markets for assets and liabilities of rural banks and endorses the provision of seasonal discount credit.