ILLINOIS FARM AND FOOD OUTLOOK

COLLEGE OF AGRICULTURE
DEPARTMENT OF AGRICULTURAL ECONOMICS

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FOCUS ON INTEREST RATES

THE VOLUME OF FARM DEBT CONTINUES TO EXPAND. As such, the cost of money is a major concern. In 1975, short-term rates on agricultural loans were fairly stable at commercial banks, and there was a general decline in these rates at Production Credit Associations. By the end of 1975, bank and PCA rates were in the same range. Long-term rates on farm mortgages remained high by historical standards, moving generally to 9 percent or above during 1975.

Interest rates on agricultural loans show much less fluctuation than money market rates, such as those on Treasury Bills or federal funds (reserves held by commercial banks which are bought and sold daily). Increasingly, farm loan rates tend to follow money market rates.

The major factors influencing the money market include: (1) Massive borrowing requirements of the Treasury. Net government borrowings were $85 billion in 1975, with projections of $87 billion for 1976. A substantial reduction in private and business borrowings in 1975 offset the large government borrowings, reducing the total demand on the money market for funds. (2) Speed of recovery from the recession. Business and industrial loan demands were down rather sharply in 1975. As inventories were depleted, capital expansion was curtailed and consumers borrowed less and bought less. The actual rate of inflation dropped, as did that of expected inflation. As the economy picks up steam, the demand for credit from both business and consumers is likely to expand. (3). Federal Reserve System actions to increase or decrease the money supply, which includes cash and currency plus demand deposits at banks. The Federal Reserve System is a major cog on the supply side. Their target is a slow but steady recovery, attempting to foster solid growth while controlling inflation. If the Federal Reserve overreacts and keeps the money supply too tight in relation to heavy borrowing demands by the treasury, interest rates for consumers and business will increase in order to ration and allocate available funds. On the other hand, allowing the money supply to grow faster than real production will hold rates down in the short run but increase inflation in the long run, causing savers to demand higher interest rates as a protection against expected inflation.

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Short-term money market rates seem to have bottomed out, and may show a moderate upward pressure as we move toward the summer of 1976. Beyond that and into 1977, there are prospects of substantial upward pressures on interest rates. The margin between short- and long-term rates will probably narrow to a more typical relationship, since long-term rates are expected to hold fairly steady through most of 1976.

Commercial banks and PCA's are the major institutional suppliers of agricultural loans that are not used to buy land. The PCA's get their money through the sale of bonds and debentures in the money market. The cost to the farmer is adjusted monthly, based on the average cost of money in the money market plus the operational costs of the PCA. The drop of about 1.5 percentage points during 1975 left PCA rates between 8.0 and 9 percent. This level is holding, and should remain stable well into the fall. The timing and intensity of upward pressures on rates will follow the money market rates.

Commercial bank rates were stable in 1975, running 8 to 9 percent. Currently, banks are in a fairly liquid position resulting from strong deposits at the end of 1975. More of their deposits are on time, which increases the costs over demand deposits. Ample funds coupled with lower-rate investment alternatives create a strong prospect that commerical bank rates will hold steady through 1976.

Long-term farm mortgage rates are likely to remain at or above 9 percent during 1976. One exception may be the commercial banks, but their available funds for mortgage lending are normally quite limited.

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