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U.S. AGRICULTURAL CREDIT CONDITIONS: *A Softening in 2006?*

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Farm credit conditions throughout the nation were healthy entering 2006, and farmland values continued to increase robustly. Surveys conducted by several Federal Reserve banks track trends in the farm economy. According to the surveys, farm borrowers were timely with their loan payments in 2005, leading to historically low delinquencies on farm loans. Requests for extensions on farm loans remained in check in most areas. A strong farm economy in recent years as well as strong demand from nonfarm buyers has boosted farmland values.

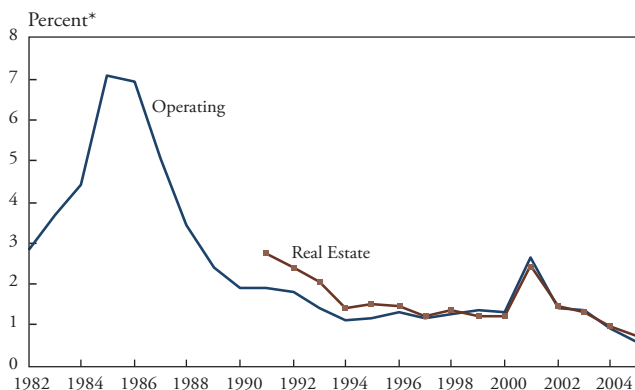
Notwithstanding strong farm finances in 2005, bankers have raised concerns about the outlook for 2006. Rising operating costs have dampened income expectations. Drought conditions in major agricultural regions could trim production and incomes this year. Many are wondering whether 2006 will be the year that farm credit conditions soften and land values cool.

FARM FINANCIAL CONDITIONS ENTERED 2006 ON SOLID GROUND

Farm credit conditions remained healthy at the end of 2005. According to bank call report data, farmers are repaying their loans in a timely fashion.

The shares of operating and real estate farm loans classified as noncurrent in the fourth quarter of 2005 were well below the long-term trend (Chart 1). Only 0.6% of farm operating loans and 0.75% of real estate loans held by commercial banks were noncurrent at the end of last year. Similar levels of historically low delinquency rates were reported by other agricultural lenders as well.

Chart 1
Noncurrent Farm Loans
(U.S. commercial banks)



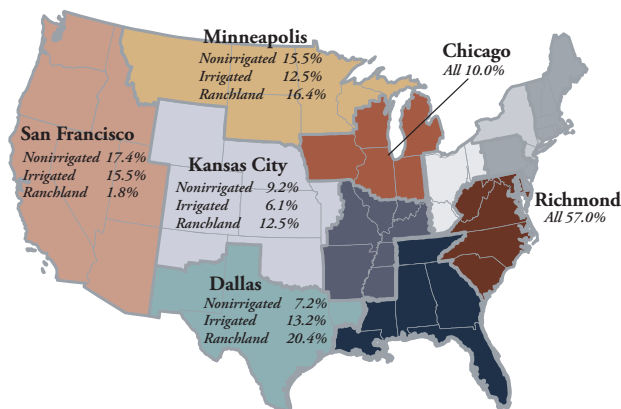
Source: Federal Reserve System

* Share of all such loans at least 90 days past due or nonaccruing; fourth quarter data.

Surveys of agricultural credit conditions conducted by six Federal Reserve banks corroborate the bank data. The survey results indicated that loan repayment rates continued to rise in the fourth quarter of 2005, as the repayment index remained at or above 100 in all districts except Chicago (Chart 2).¹ Repayments were especially strong in the Minneapolis and San Francisco districts, as 25% and 32% of bankers, respectively, reported higher rates of loan repayment. Although surveys indicated loan demand was higher in five of the six districts, bankers reported that the availability of funds was adequate to service the higher loan demand.

Land values have been exceptionally strong in recent years. Gains in values surged to record levels from 2003 to 2005 in many parts of the country. Gains in good quality (nonirrigated) farmland ranged from 7.2% to 17.4% in most Federal Reserve districts in 2005 (Figure 1).² Ranchland values again posted double-digit gains in many parts of the nation, with the Dallas District reporting an increase of 20.4% for ranchland real estate. Gains in ranchland values were especially strong in southwest Texas (Dallas District) and in Oklahoma (Kansas City District). With high energy costs, gains in irrigated values generally trailed both nonirrigated and ranchland value gains. Surveys conducted at several land grant universities reinforce the trends seen in the Federal Reserve survey results.

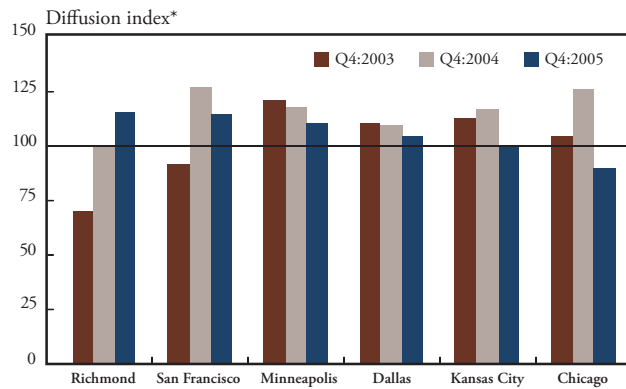
Figure 1
Farmland Value Gains
Federal Reserve District agricultural credit surveys



Sources: Federal Reserve Banks of Kansas City, Chicago, Dallas, Richmond, and Minneapolis (San Francisco computed by Kansas City).

* Percent changes are 4th quarter 2005 over 4th quarter 2004.

Chart 2
Farm credit conditions
Loan repayment rates



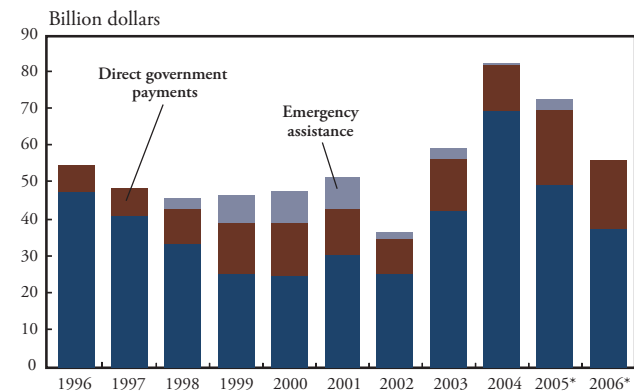
Sources: Federal Reserve Banks of Chicago, Dallas, Kansas City, Minneapolis, Richmond, and San Francisco (computed by Kansas City)

* Bankers responded to each item by indicating whether conditions during the current quarter were higher than, lower than, or the same as in the year-earlier period. The index numbers are computed by subtracting the percent of bankers who responded "lower" from the percent who responded "higher" and adding 100.

Several forces driving farmland values remained in place in 2005. First, national net farm income was a near record, second only to 2004 (Chart 3). The strong farm incomes were aided by record large government payments. Relatively low long-term interest rates added to the favorable financial situation for farmland buyers.

Although farmers remained the largest group of farmland buyers in most areas, nonfarm demand

Chart 3
U.S. Net Farm Income



Source: USDA

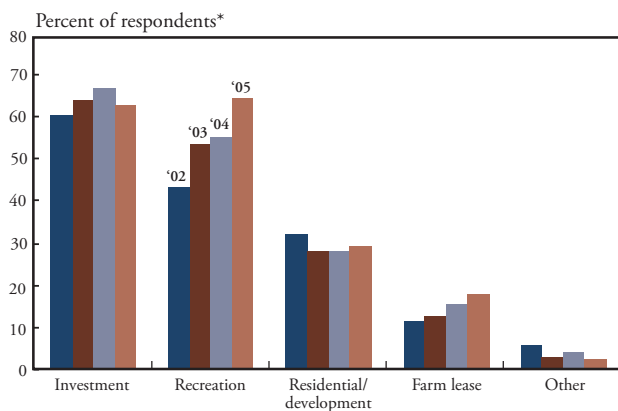
* Forecast, February 2006

continued to underpin land markets in 2005. Investors and other buyers using 1031 tax-deferred exchanges were active in many markets. A survey conducted by the Illinois Society of Professional Farm Managers and Rural Appraisers in mid-2005 found that 56% of all buyers in Illinois were using these tax-deferred exchanges and that the tax breaks were a major reason for increases in farmland prices.³ With a limit on the time that can elapse between the original property sale and the new property purchase, these buyers tend to be aggressive and often are willing to pay high prices.

Buyers also appear to have ample cash for land purchases. Iowa State University's annual land value survey, conducted in November 2005, found that the cash liquidity of buyers was one of the strongest factors affecting land values in the state.⁴ The Illinois survey found that 62% of buyers did not need debt capital to finance their land purchases, a 10% increase over 2004.

Finally, sales of farmland for recreational use have been on the rise. The Kansas City District's survey asked bankers the leading reasons for farmland purchases by nonfarmers (Chart 4). In the fourth quarter of 2005, 66% of respondents reported that recreation was a major reason for purchases by nonfarm buyers, surpassing investment as the most popular reason for nonfarmer purchases.

Chart 4
Reasons for Farmland Purchases by Nonfarmers
Kansas City District (fourth quarter)



Source: Federal Reserve Bank of Kansas City

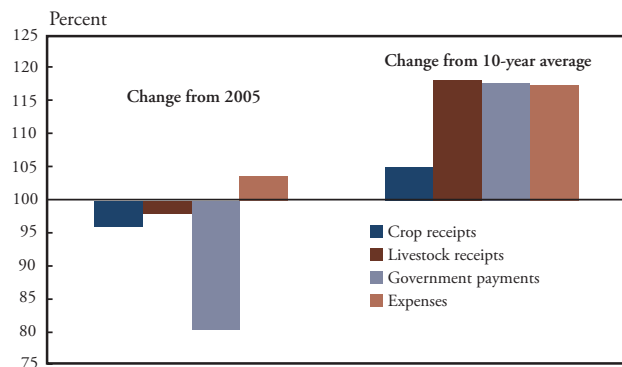
* Respondents were asked the most common reasons for farmland purchases by individuals other than farmers. Respondents could choose more than one response, and therefore, percentages will not sum to 100.

FARM CREDIT CONDITIONS MAY WAVER IN 2006

Although farm loan portfolios were healthy overall and farmland values were solid at the end of 2005, several signs suggest more caution in the year ahead. Farm incomes are expected to fall from the record levels of the previous two years. Drought conditions have spread across major agricultural regions, sapping soil moisture levels and leading to worsening pasture conditions.

Net farm income is expected to fall 23% in 2006, according to USDA projections (Chart 3). The decline is due to sharply lower government payments, lower crop and livestock receipts, and higher expenses (Chart 5). From a longer-term perspective, both cash receipts and government payments are expected to be well above the 10-year average. Sharp increases in expenses, however, will keep overall net farm income just above the 10-year average.

Chart 5
Changes in 2006 Farm Income



Source: USDA

As a result of the lower income expectations, signs of weaker capital spending have emerged. Bankers in the Kansas City District reported lower capital spending in the second half of 2005 and expected the trend to continue into 2006. The Chicago and Minneapolis surveys also suggest a slower pace of investment.

Drought conditions across the Midwest, Southwest, and East are a risk to farm incomes and could cause credit conditions to deteriorate in 2006, especially in affected areas. Chicago's index of loan repayment rates dropped significantly in the fourth quarter of 2005, compared to the previous year. Some of the decline was attributable to a sharp drop in Illinois, where a summer drought trimmed 2005 incomes. More recent drought conditions in the Dallas and Kansas City districts have deteriorated winter wheat and pasture conditions, forcing some cattle producers to cull their herds. The Dallas survey recently described the outlook for production in 2006 as "bleak." Timely rains will be needed in many regions to replenish low moisture levels and prevent serious deterioration in credit conditions.

Other indications of a potential slowdown are changes in farm credit conditions. The index of renewals and extensions increased in four of six Federal Reserve districts—the Chicago and Kansas City indexes moved above 100, suggesting that more farm customers had difficulty servicing their debt than in recent years. Although the loan demand index fell in most districts in 2005, indications are that higher farm expenses will increase the demand for loans in 2006. The index of loan demand was already higher in Chicago in the fourth quarter. Bankers in the Dallas District expected the volume of feeder cattle loans to increase in the first part of 2006 due to high feeder cattle prices and the drought-induced shortage of forage that has pushed the cost of supplemental feed higher. And nearly a third of Kansas City bankers expected higher loan demand in the first quarter of 2006, relative to the previous year, due to rising fertilizer bills and skyrocketing fuel costs.

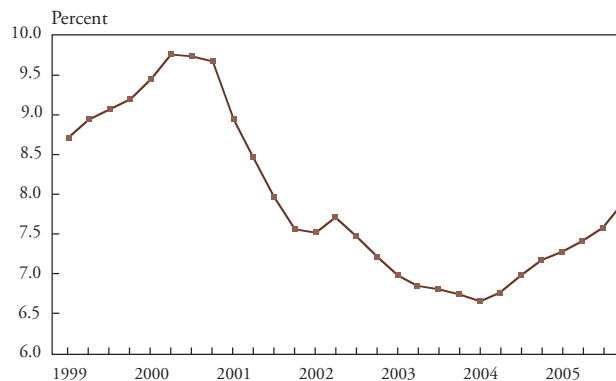
FARMLAND VALUES MAY BE COOLING OFF

While farmland values posted record or near-record gains in 2005, the expected decline in farm incomes could limit the willingness of farmers to pay higher prices for farmland. Interest rates are also on the rise, and the housing market is slowing, which could dampen nonfarm demand. Alternative investments recently have become more attractive relative to farmland.

Farm incomes are expected to decline in 2006, falling back in line with the long-term average. In addition, the current farm bill is set to expire next year. The large federal deficit and ongoing trade negotiations could signal fewer funds allocated to commodity programs in the next farm bill. If true, smaller commodity payments along with average farm incomes would have a negative impact on farmland values.

Another potentially negative force is the slowdown in the nation's housing market. With home sales down and housing inventories rising, demand for development may slow. Housing inventories are rising, in part due to a recent rise in mortgage rates. Interest rates on farm real estate loans have also been rising over the last two years, and in the fourth quarter were just under the levels of mid-2001 (Chart 6).

*Chart 6
Farm Real Estate Interest Rates
Kansas City District*



Source: Federal Reserve Bank of Kansas City

Investor demand may also cool as returns on alternative investments, including the stock market, improve. Uncertain stock market returns beginning in the early 2000s encouraged some investors to turn to land as a more stable investment, but higher returns on financial investments could reverse this trend.

While most market participants expect the farmland market to slow somewhat in 2006, a significant decline in farmland values seems unlikely. About three-fourths

of bankers responding to the Kansas City survey expect farmland values to remain flat in early 2006. Still, nearly a fourth expect continued increases in ranchland values, while just under a fifth expect cropland values to rise. Similarly, roughly a third of bankers in the Chicago District expect farmland values to rise. The Illinois survey, as well as those conducted by the University of Missouri and Purdue University, suggests expectations for farmland gains in the range of 5% for 2006, half the gains of recent years. The Iowa State survey indicates that a large share of farmland is owned without debt, which reduces the risk of large declines in land values like those experienced in the 1980s.

Agricultural credit conditions may soften in 2006, but a steep worsening is not expected. Farm loan portfolios are healthy, and farm balance sheets are strong. The U.S. debt-to-asset ratio is the lowest in at least 40 years. While price appreciation appears to be slowing, farmland values are not expected to fall. The current healthy state of the farm sector overall should cushion the descent, but the impacts of drought conditions in some areas merit watching.

ENDNOTES

- ¹ Diffusion indexes are calculated for the survey data. The index is computed by subtracting the percent of bankers who responded “lower” from the percent who responded “higher” and adding 100. An index above 100 denotes that the responses were higher on average, and an index below 100 indicates that the responses were lower on average.
- ² The Richmond District, which has fewer agricultural banks, reported farmland gains of 57%.
- ³ Aupperle, Dale E., Jerry R. Hicks, and Gary Schnitkey. “2005 Mid-Year Illinois Land Values Survey,” Illinois Society of Professional Farm Managers and Rural Appraisers, August 31, 2005, www.ispfmra.org/land-values.html.
- ⁴ Duffy, Michael D., and Darnell Smith. “2005 Iowa Land Value Survey: Overview,” University Extension, Iowa State University, December 13, 2005, www.econ.iastate.edu/faculty/duffy/Pages/2005Ivsoverview.pdf

Fed Survey Summaries on the Web

Chicago: www.chicagofed.org/economic_research_and_data/ag_letter.cfm

Dallas: www.dallasfed.org/research/agsurvey/index.html

Kansas City: www.kansascityfed.org/agcrsurv/Agcrmain.htm

Minneapolis: <http://minneapolisfed.org/pubs/agcredit/>

Richmond: www.richmondfed.org/research/regional_conditions/agriculture/index.cfm

Note: A Summary is not available for San Francisco, but additional information from their survey can be found at: www.federalreserve.gov/releases/e15/