

Credit in Rural America

This report assesses the demand for and availability of credit in rural areas for agriculture, housing, and rural development, as mandated by Section 650 of the Federal Agriculture Improvement and Reform Act of 1996. Its purpose is to provide the most recent and comprehensive information available on the performance of rural financial markets as Congress deliberates on legislation addressing agricultural and rural credit issues, including the availability of credit and changes in Federal credit policy.

The 1996 Act specifically requested that the study be based on the most recently available data to analyze:

- (1) rural demand for credit from the Farm Credit System, the ability of the Farm Credit System to meet the demand, and the extent to which the Farm Credit System provides loans to satisfy the demand;
- (2) rural demand for credit from the United States banking system, the ability of banks to meet the demand, and the extent to which banks provide loans to satisfy the demand;
- (3) rural demand for credit from the Secretary, the ability of the Secretary to meet the demand, and the extent to which the Secretary provides loans to satisfy the demand;
- (4) rural demand for credit from other Federal agencies, the ability of the agencies to meet the demand, and the extent to which the agencies provide loans to satisfy the demand;
- (5) what measure or measures exist to gauge the overall demand for rural credit, the extent to which rural demand for credit is satisfied, and what the measures have demonstrated;
- (6) a comparison of the interest rates and terms charged by the Farm Credit System Farm Credit Banks, production credit associations, and banks for cooperatives with the rates and terms charged by the

banks of the United States for credit of comparable risk and maturity;

(7) the advantages and disadvantages of the modernization and expansion proposals of the Farm Credit System on the Farm Credit System, the United States banking system, rural users of credit, local rural communities, and the Federal Government, including:

- any added risk to the safety and soundness of the Farm Credit System that may result from approval of a proposal; and
- any positive or adverse impacts on competition between the Farm Credit System and the banks of the United States in providing credit to rural users;

(8) the nature and extent of the unsatisfied rural credit need that the Farm Credit System proposals are supposed to address and what aspects of the present Farm Credit System prevent the Farm Credit System from meeting the need;

(9) the advantages and disadvantages of the proposal by commercial bankers to allow banks access to the Farm Credit System as a funding source on the Farm Credit System, the United States banking system, rural users of credit, local rural communities, and the Federal Government, including:

- any added risk to the safety and soundness of the Farm Credit System that may result from approval of the proposal; and
- any positive or adverse impacts on competition between the Farm Credit System and the banks of the United States in providing credit to rural users; and

(10) problems that commercial banks have in obtaining capital for lending in rural areas, how access to Farm Credit System funds would improve the availability of capital in rural areas in ways that

cannot be achieved in the system in existence on the date of enactment of this Act, and the possible effects on the viability of the Farm Credit System of granting banks access to Farm Credit System funds.

For a number of reasons, this study is unable to respond fully to several of these issues, at least as they have been posed. Time restrictions and data availability are both limiting factors. In addition, the nature of credit markets, where each participant's behavior is affected to some degree by that of its competitors, makes evaluation of individual participant performance difficult. Nonetheless, every attempt has been made to address each of the issues raised, to the extent possible.

While the thrust of many of the mandate's questions is on demand for credit, this study includes information about the supply of credit and credit substitutes (outside equity capital and Federal grants) that Congress did not specifically request in an attempt to provide a more comprehensive view of the financial landscape faced by rural borrowers. Nonetheless, this analysis focuses on the aggregate performance of rural financial markets for each of the broad classes of borrowers mentioned in the Congressional mandate rather than on the performance of individual markets. That is, available data and financial market research have been reviewed to ascertain if rural residents face widespread problems in accessing competitively priced credit. No attempt has been made to evaluate financial market conditions in specific rural communities or to highlight any sporadic or localized financial market failures that may exist in rural America.

This aggregate approach is consistent with the types of policy changes the Congress requested USDA to assess. Expanding the lending authority of the Farm Credit System (FCS) and the commercial banking system's access to FCS funds are both "broad-brush" policy changes aimed at increasing rural credit availability. Neither approach targets documented financial market problems affecting specific communities or specific groups of borrowers. Furthermore, since the public benefits of both proposed policy changes accrue only in markets where competitive performance is improved, neither policy change will be cost effective unless rural financial market problems are widespread. In contrast, cost-effective solutions to credit problems that are localized, sporadic, or limited to particular borrower groups would entail tightly targeted policy

"Rural" is a Matter of Perspective

For our purposes, "rural" is synonymous with "non-metropolitan." Both terms refer here to counties that are not part of a metropolitan statistical area as defined in 1993 (based on population and commuting data from the 1990 Census). The United States had 2,288 nonmetropolitan counties in 1993, accounting for 83 percent of the Nation's land and 21 percent of its population. (For a more complete description of the rural economy, see *Understanding Rural America*, published by USDA.) While this definition is commonly used because of the availability of county-level data, it is not universally accepted and many Federal programs and economic studies use alternative definitions.

The Census Bureau classifies open country and communities with populations under 2,500 located outside urbanized* areas as "rural." This definition includes large sparsely populated portions of metropolitan areas, but excludes cities in remote nonmetropolitan locations. USDA's rural development programs use a number of different population size limits to determine eligibility. The Business and Industry loan program serves eligible borrowers in open country and in cities of under 50,000. The guaranteed housing program serves open country, metropolitan cities with less than 10,000 residents, and nonmetropolitan cities of less than 20,000. Aggregate "rural" data will differ as the definition changes, but since nonmetropolitan areas constitute a major portion of each of the commonly used definitions of "rural," the same general patterns we report should emerge using other definitions.

* Urbanized areas are cities and built-up surrounding areas that, together, contain at least 50,000 people.

approaches based on additional study. Examples of such policies might include lowering barriers to entry, reducing the costs of serving poorly functioning markets, or providing subsidies that are directly related to market performance.

Rural Credit Demand, Its Satisfaction, and Rural Credit Supply

The legislative language requesting this report focuses on rural credit demand and the satisfaction of that demand. "Rural" is left undefined, and different programs, studies, and data sources use different definitions (see box). In this study, "rural" means nonmetro-

politan counties whenever data are presented. However, the literature referred to often relies on alternative definitions. The phrase *credit demand* is also open to interpretation. In this report, we use the economic definition: demand is the amount of credit (of a certain type, maturity, etc.) that borrowers will choose to incur and pay for at a given price. Such decisions depend on both economic considerations and consumer preferences. Economic considerations include such factors as the borrower's income and the prices and qualities of other goods and services. Noneconomic considerations include such factors as the borrower's willingness to defer consumption or investment until sufficient savings can be accumulated and his or her community's view of debt. Although credit markets are complicated because they involve transactions that occur over extended periods of time and involve sellers who cannot verify that they will receive payment for their services, the basic economic principles apply.

The desires of potential consumers who are unwilling or unable to pay are not included in economic demand. In this way credit is no different from other goods and services. Requests from those who are unable or unwilling to repay loans and their associated costs cannot be considered to create economic credit demand. If they were, demand would quickly outpace supply, and we would have to use a nonmarket mechanism to allocate the limited amount of loanable funds available. Attempts by other societies to rely heavily on nonmarket mechanisms for allocating credit have met with only temporary and limited success.

The *ability to satisfy credit demand* is linked closely to the definition of credit demand. As discussed, "credit demand" refers to the relationship between the amount of credit borrowers choose to use and the price they must pay for that credit, holding other things constant, including income and other prices. Not all demands are satisfied in any market at any time because a price exists below which a given good or service will not be voluntarily traded by providers.

From a rural development policy perspective, the key questions concerning the satisfaction of credit demand are:

- whether the equilibrium price for credit (i.e., the effective interest rate at which supply equals demand) is significantly different in rural and urban financial markets;

- whether rural lenders can respond in a timely fashion to changes in the level of legitimate loan requests by creditworthy borrowers; and
- whether rural financial markets are sufficiently competitive to allocate credit efficiently.

A higher effective interest rate in rural areas is not proof that a rural credit market problem exists, nor are equivalent interest rates in rural and urban areas proof that credit market problems do not exist. Interest rates should vary with the riskiness of the loans being made and other lending costs. But since transactions costs, barriers to entry, and imperfect information reduce the geographic mobility of financial capital, differences in interest rates can also result from local financial market imperfections. These imperfections, if they exist, are concerned more with the supply of credit and the structure of financial markets than they are with demand for credit.

Thus, a key concern is whether rural financial markets can quickly adjust to changes in legitimate requests by creditworthy borrowers. Such changes may occur, for example, because profitable investment opportunities arise as prices, technology, or consumer preferences change. The final issue is whether or not the equilibrium level of credit in a given market is consistent with efficient economic performance. An equilibrium level may be inefficient if supply conditions are not competitive because of such factors as naturally monopolistic markets, legal constraints to competition, unwillingness to provide credit to certain types of borrowers or for certain purposes, inability of lenders to efficiently diversify or hedge risks, and the inability of lenders to correctly verify the willingness and ability of borrowers to repay loans and interest. In assessing the performance of rural financial markets, each of these issues will be addressed to the extent that data allow (see box, "Data Limitations").

Measuring and Evaluating Market Performance

For the most part, this study adopts an economic efficiency framework to discuss the qualitative performance of rural markets. In an efficient capital market, all borrowers having the same creditworthiness have similar access to credit, with the cost of borrowing being a function of the riskiness, term to maturity, and other cost-related characteristics of the loan. The

Data Limitations

Data limitations required significant adjustments in the focus of the report. Definitive information pertaining to the following issues is not available:

- economic measures of rural credit demand and its satisfaction;
- comparisons of the cost of credit of comparable risk and maturity from different lenders;
- accurate measures of rural financial market performance and concentration; and
- the magnitude of likely benefits from improving the competitive performance of rural financial markets through additional FCS activity.

As discussed elsewhere, measuring unsatisfied economic demand for any good or service is difficult, but doing so is nearly impossible for financial services because of the added dimensions of risk and informational problems. Information on the qualifications of loan applicants, loan terms, and financial market conditions is needed to compare market outcomes. For housing loans, the Department of Housing and Urban Development collects information under the Home Mortgage Disclosure Act (HMDA) on all applications for mortgages (from particular institutions). While this data is not comprehensive, it does provide uniform information on the percent of denials by type of institution, location, and race of applicant. Such information may be helpful, but it is not conclusive because detailed information on an applicant's financial status, and thus whether an application is denied for economic or other reasons, is not collected. Unfortunately, HMDA information is generally unavailable on rural credit applicants since many rural lenders are exempt from the reporting requirements. Similar information is not collected on applications for other types of loans from either rural or urban lenders, leaving very little direct evidence of variation in unmet demand for credit.

While information sufficient to assess variations in the demand for credit is not available, other indices exist for gauging the performance of rural financial markets. By relying on these subjective indicators and by focusing on the ability of rural lenders to respond to increases in the demand for credit—and the likelihood that market forces will be conducive to their doing so—this study addresses the underlying issue of whether additional Federal intervention in rural credit markets could be warranted.

Comparing credit costs across lenders for loans of comparable risk and maturity is also impossible with available

data. Doing so requires information linking borrower characteristics to loan characteristics—such as fees, maturity, collateral, and pricing. Although several data sources contain loan level interest rates on loans to agriculture, housing, and small businesses in rural areas, these sources do not include important information about noninterest borrowing costs and loan riskiness. Data are unavailable on such relevant items as origination fees, stock purchase requirements, compensating balances in deposit accounts, borrower income, debt level, and estimated repayment capacity. Such data are necessary to make comparisons of credit costs as meaningful as possible since markets vary with borrower characteristics as well as loan products; each lender type often serves a slightly different set of borrowers or financial service needs. In addition, to protect lender confidentiality and borrower privacy, data linking loans to the geographic location of borrowers or lenders were often unavailable for analysis. This data gap prevents analysis of the relation between market conditions and loan characteristics.

Even determining the relevant market and the competitive environment within that market is far from straightforward. The choice of potential lenders a borrower faces varies with the size and type of loan, the size and type of borrower, the borrower's location, and a host of other factors. While county or metropolitan area boundaries are often used to measure market concentration, they are arbitrary and potentially misleading. Furthermore, since data on the geographic distribution of lending activity is seldom available, most measures of market concentration are based on deposits, ignoring the impact of nondepository lenders such as the Farm Credit System.

Finally, in weighing the costs and benefits of additional FCS activity, an important factor is the likelihood that such activity will have measurable impacts on the competitive performance of individual credit markets. No quantitative information on the link between FCS activity and credit market performance could be found in the literature.

Despite shortcomings in available data, the conclusions of this report, focusing as they do on broad trends and conditions, rest on a solid foundation. General knowledge of financial markets, previously published research on financial market performance and imperfections, and the empirical analysis completed for this report are all used to respond to the issues this study was asked to address. This report strives to indicate clearly both the limits of current knowledge of rural financial markets and what is known with confidence.

major components of the cost of credit are the cost of capital and the cost of risk-bearing, neither of which should vary geographically in an efficient capital market.¹ Variations in personnel and other costs remain, but these have a relatively minor impact on the cost of credit. Thus, in efficient markets, otherwise identical borrowers face similar supply curves for credit, no matter where they reside. Differences in the use of credit in such markets are a function of demand.

Competitive financial markets allocate capital efficiently, but not all markets are equally competitive. When few competitors dominate a market, they have the power to affect equilibrium prices and quantities. At the extreme, profit-maximizing monopolists restrict supply, thereby increasing the price above that which would prevail in a competitive market. Market power can be used in this way to earn extra profits, or it can support inefficient operations that spend more than necessary on salaries, buildings, or other inputs that benefit managers and owners but not customers. While insufficient data are available to precisely measure rural financial market performance, measures of market structure are more readily available; and a large body of research exists linking structure to performance (see Gilbert, 1984; and Rhoades, 1995).

Market power can persist and local financial market conditions vary significantly because the following factors all reduce competition between lenders in different geographic regions and specializing in different loan products:

- high information and transactions costs;
- low profit potential from new entry;
- regulated, legislated, and institutionalized market segmentation;
- informational asymmetries; and
- cultural or personal biases (discrimination).

¹ In an efficient market, capital is free to flow to its best use, and only risk that cannot be eliminated in an efficiently diversified investment portfolio is priced—and that price should not vary with where the loan is originated or held. Nor should the cost of credit vary appreciably by the size of the lender. Economies of size and scope are relatively minor in the commercial banking industry, with fairly small banks (with assets of \$75 million to \$300 million) exhibiting minimum average costs (Berger and Humphrey, 1992).

As a result of market segmentation, borrowers in different markets often face different supply curves. Market segmentation refers to the division of markets (here the market for borrowed funds) into insulated parts or submarkets. Such segmentation can occur, for example, because of geographic isolation, transaction costs, or legal barriers to competition. Segmentation may limit the number of competitors in a submarket and allow them to earn greater profits or operate less efficiently than they would in a more competitive environment. The insulation of the segments need not be total for these effects to occur. Thus, similar loan requests from borrowers having the same characteristics may be treated very differently from one community to the next, and borrowers with similar loan purposes or collateral may be treated differently depending on the type of lender they approach.

In considering credit demand from commercial sources, such as the Farm Credit System or commercial banks, an economic efficiency perspective is appropriate. However, the Federal Government has intervened in rural credit markets for two reasons: to enhance economic efficiency and to address concerns about social equity or fairness. While these two concerns often arise in tandem, they have very different aims and implications for demand. Moves toward market efficiency add to the resources available to society, and, therefore, are potentially self-financing. Appropriately priced “market efficiency” program funds can be allocated the same as private-sector loans are to meet demand. But programs to attain social fairness through credit markets tend to create economic inefficiencies, requiring public subsidies to attain program goals.

Government programs that provide subsidized credit attempt to bolster the economic activity or well-being of those served (who may or may not qualify for commercial credit). Demand for subsidized credit is largely insatiable because of the economic benefits bestowed on recipients through preferential loan terms. Thus, the ability of subsidized government programs to satisfy borrower demand is irrelevant. Rather, their effectiveness depends solely on their ability to cost-effectively satisfy their public purpose. Judging how “fair” the results are requires a set of value judgments about who does and does not deserve credit and how much subsidy (both directly, in terms of borrowing costs, and indirectly, in terms of forgone economic growth) society is willing to provide. These judgments

are best addressed through the political decisionmaking process and are not evaluated in this study.

In addressing the 10 issues raised by Congress, this report first addresses the ability of the major rural lender categories to meet changes in the level of demand in a timely fashion and the extent to which they have provided rural loans for various purposes in the recent past (addressing parts of questions 1 through 4 on page 1). The study then assesses the demand for credit by agriculture, and the rural housing, business, and community development sectors, and evaluates how well rural financial markets appear to be satisfying that demand (addressing parts of questions 1 through 6). Based on this research, the need for an expanded FCS role in rural financial markets is examined (addressing questions 7 through 10). This report is supplemented by several lengthy appendices which provide more detailed evidence on each of these issues.

Rural Lenders

Rural borrowers are served by a wide variety of financial service providers. The most visible sources are regulated financial institutions—particularly commercial banks, savings and loans (for housing), and the FCS (for agriculture). However, other institutions and individuals play important roles by supplying credit or by enhancing the competitiveness of rural financial markets. Table 1 lists the potential sources of credit and financial market support for agriculture and rural housing, business, and development. (Appendix A provides a more detailed overview of these financial service providers and their importance in rural America, and discusses some of the trends and policy developments affecting their performance.) Retail lenders are responsible for originating loans; the degree of competition among them can determine how efficiently borrowers are served. The type of financing supplied by retail lenders is a function of their charter (which defines the scope of their lending authority), safety and soundness considerations, comparative cost and marketing advantages, source of funds, and alternative investment opportunities. As a result, most retail lenders are not major sources of credit for all borrower categories, and they often specialize in providing particular types of loans or serving particular risk classes of borrowers within the markets they serve. The resulting segmentation of credit markets along product, geo-

graphic, and borrower characteristic lines reduces competition among lenders.

In part, government-supported secondary markets and credit enhancement programs were initiated to help foster greater competition for eligible loans. They encourage the creation of new competitors, or increase the size of the market served by existing lenders and increase the lending capacity of lenders within a given market. Borrowers do not typically interact directly with the institutions and entities listed on the lower half of table 1. These organizations typically deal with retail lenders, buying eligible loans, serving as conduits or guarantors for the sale of mortgage-backed securities, providing cash advances, and guaranteeing or insuring eligible loans originated by lenders. Nonetheless, their existence has had a marked impact on retail lender behavior and, to varying degrees, on financial market performance.

The Congressional request for this study specifically asked for information on the commercial banking system, the Farm Credit System, credit programs operated by USDA, and credit programs administered by other Federal agencies. The remainder of this section focuses on these lender groups, describing the markets they serve, their current financial strengths and weaknesses, and factors affecting their abilities to respond to changes in economic demand for credit.

Commercial Banks

By any measure, commercial banks dominate most rural financial markets and are well positioned to provide financial support to rural sectors of the economy. Since 1991, loan loss provisions and problem loans have declined for commercial banks nationwide. Bank profitability is high, as are interest rate margins and capital levels. The financial condition of banks headquartered in rural America was particularly healthy going into 1996 (fig. 1).

Rural banks provide credit for a wide range of uses, including home mortgages, consumer loans, agricultural loans, and commercial/industrial loans. In addition to lending, rural banks hold tax-exempt securities used to finance State and local government activities. Loans held by rural banks reflect the local economies they serve. Agricultural loans are a higher share of total loans than commercial and industrial loans, and both are far less prevalent than home mortgages (fig. 2).

Table 1—Sources of credit for agriculture and rural housing, business, and development*Credit sources vary depending on the nature of the loan.*

Type of lender	Type of loan			
	Agriculture	Housing	Small business	Community development
Retail lenders:				
	<i>Relative importance of lender</i>			
Regulated financial institutions				
Commercial banks	major	major	major	major
Farm Credit System	major	minor	minor	minor
Thrift institutions	minor	major	minor	minor
Insurance and pension funds	moderate	—	moderate ¹	minor
Unregulated lenders				
Finance companies	moderate	minor	moderate	—
Mortgage brokers	minor	major	—	—
Trade credit suppliers	moderate	—	moderate	—
Nonprofits (revolving loan funds, etc.)	—	minor	minor	minor
Individuals	moderate	moderate	moderate	moderate
Government direct loan programs				
U.S. Department of Agriculture	moderate	minor	—	minor
Other Federal agencies	—	minor	minor	—
State and local agencies	minor	minor	minor	major
Secondary markets and credit enhancements:				
Government-sponsored enterprises				
Federal National Mortgage Assn.	—	major	—	—
Federal Home Loan Mortgage Corp.	—	major	—	—
Federal Home Loan Bank System	—	major	—	minor
Federal Agricultural Mortgage Corp.	minor	minor	minor ²	minor ²
Farm Credit System (OFI lending)	minor	—	—	—
Government agencies				
U.S. Department of Agriculture	moderate	moderate	minor	moderate
Other Federal agencies	minor	moderate	moderate	minor
State and local agencies	minor	minor	minor	minor
Private sector				
Loan poolers	minor ²	minor	minor ²	minor ²
Loan guarantors/insurers	minor	moderate	minor	minor

Note: Precise estimates of the relative importance of specific lenders within rural credit markets are generally unavailable. Categorizations are based on survey data, administrative records, and anecdotal evidence. See appendices A and B for details. A major participant provides or supports more than 20 percent of the market; moderate participants handle 5 to 20 percent of the market; minor participants handle less than 5 percent of the market.

¹ The insurance industry's assets include substantial commercial real estate holdings as well as corporate stocks and bonds and tax-exempt securities. While not considered major lenders to small independent rural business, insurance company investments may directly and indirectly finance the rural branch plants of large and medium-sized businesses.

² Support is provided primarily for federally guaranteed loans.

— Indicates no lending or an insignificant amount of lending.

Commercial banks have historically provided short- and medium-term credit for agriculture and the non-farm rural business sector. Banks have preferred short-term loans and relatively liquid investments since they rely on short-term deposits for most of their loanable funds. Nonetheless, in recent years, agricultural real estate and home mortgages have been growing within rural bank loan portfolios.

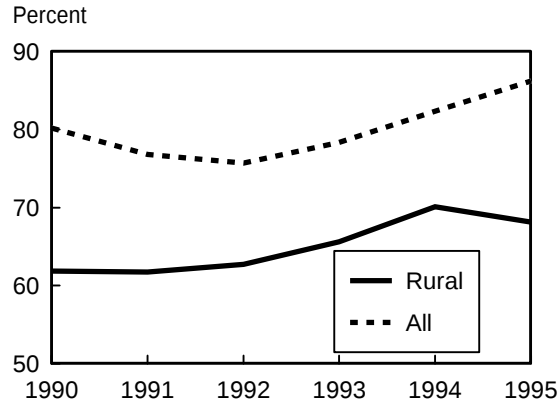
Loan-to-deposit ratios are a widely cited measure of a bank's liquidity and its ability to provide an adequate supply of loanable funds. In response to an expanding economy, average loan-to-deposit ratios at rural banks have grown since 1991. In the past, a high loan-to-deposit ratio might have caused many banks to reduce their lending efforts as they put more emphasis on retaining liquidity through holdings of cash and securi-

Figure 1

Commercial bank finances, 1990-95

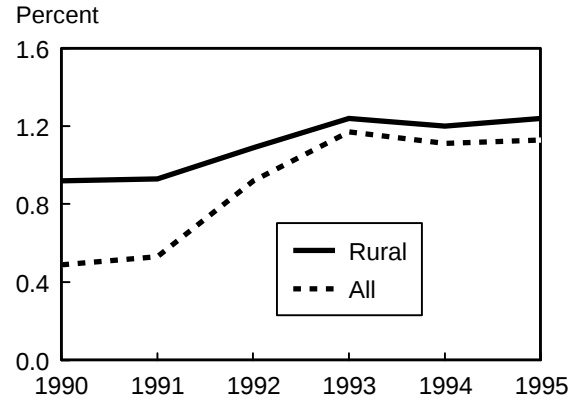
Bank loan/deposit ratios

Rural bank loan ratios moderated a bit in 1995.



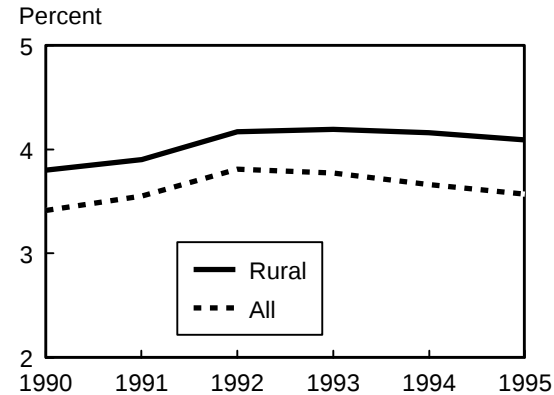
Return on bank assets

Bank profits climbed slightly relative to assets in 1995.



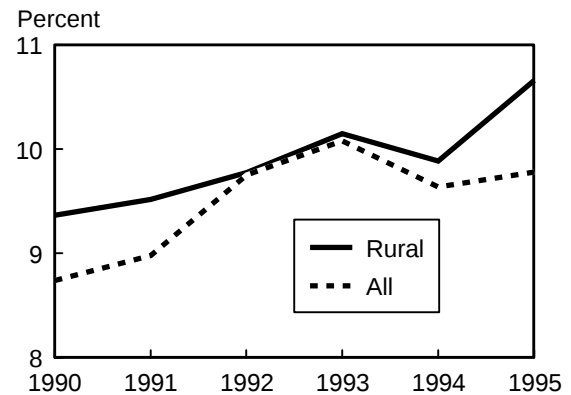
Net interest margins

Net interest margins declined but remain high enough to support strong bank profits.



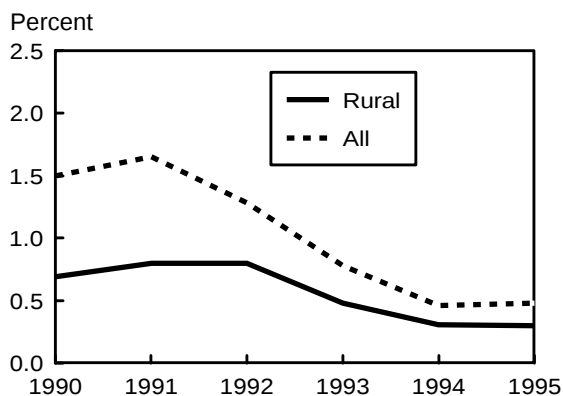
Capital/asset ratios

Capital grew rapidly as a proportion of assets at rural banks in 1995.



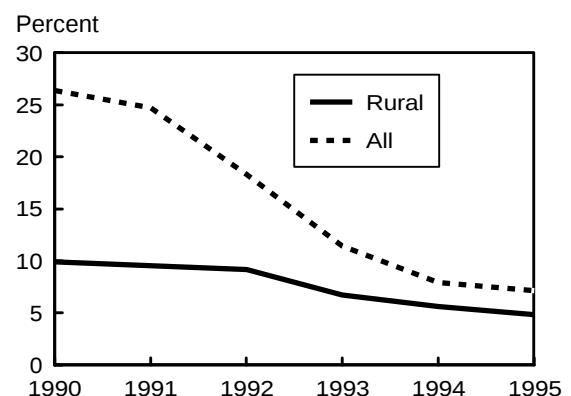
Loan loss provisions/loans outstanding

A healthy economy allowed banks to keep loan loss provisions at low levels in 1995.



Problem loans as a share of bank capital

Bad loans continued to decline relative to rural bank capital.

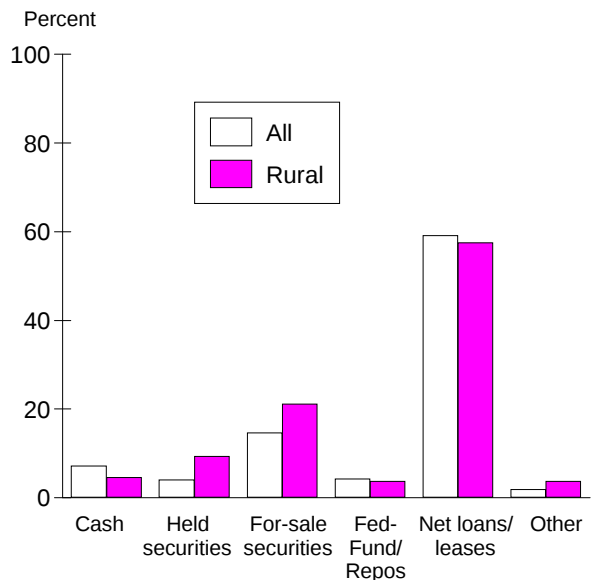


Source: Calculated by ERS from the Report of Condition and Report of Income, December 31, 1990-95.

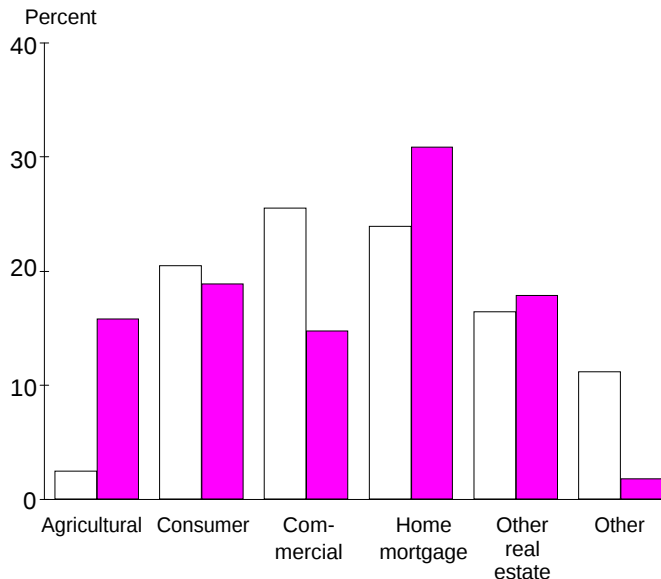
Figure 2

Distribution of commercial bank assets and loans, 1995**Asset holdings**

Rural banks hold a relatively large percentage of total assets in securities, but loans predominate.

**Loan portfolios**

Rural banks hold relatively fewer commercial loans but more agricultural loans.



Source: Calculated by ERS using data from the Report of Condition and Report of Income, Dec. 31, 1995.

ties. Also of concern is the slow growth in the banking industry's deposit base over the last several years. Between 1990 and 1995, total deposits at rural-headquartered commercial banks increased only 6 percent, compared with 14 percent industrywide.² Both growth figures are less than robust, particularly given the transfer of deposits from thrifts to commercial banks in recent years. Slow deposit growth is consistent with the growth of mutual funds and money market funds, which bankers claim are siphoning funds away from local credit markets nationwide.

Despite these trends, surveys indicate that rural bankers are not reluctant to make additional loans to creditworthy borrowers.³ In recent years, rural banks have gained access to a growing number of alternatives to

local deposits to fund new loans (see "Commercial Bank Liquidity," in appendix C). They can sell loans or securities from their portfolios or use them as collateral for short-term loans from a variety of sources.⁴ Many rural banks are now members of the Federal Home Loan Bank System, which allows them access to

² Total deposits at rural-headquartered banks reflect changes in bank structure as well as changes in depositor behavior. In particular, bank mergers and the conversion of multibank holding company affiliates into bank branches artificially inflate urban bank deposits and deflate rural bank deposits. More troubling is the sluggish growth in the industry's total deposits.

³ Agricultural banker responses to quarterly surveys conducted by the Federal Reserve Banks of Chicago, Kansas City, Dallas, Minneapolis, and Richmond indicate an increasing percentage have more funds available for lending than they did the previous quarter. For the first two quarters of 1996, a lower percentage of respondents stated that fund availability was falling than did in the previous year. (The Kansas City district had the highest percentage of agricultural banks with falling availability of funds—16 percent in June 1996 compared with 18 percent in June 1995.) Most respondents stated that their loan-to-deposit ratios were lower than desired (Walraven and Carson, 1996). Based on preliminary results from a recent nationwide survey of agricultural banks, 72 percent of respondents reported that deposits were growing fast enough to keep up with loan demand (American Bankers Association, 1996).

⁴ The outright sale of government securities is less likely these days due to accounting regulations governing the valuation of security holdings. Banks must designate securities in their portfolios that might be sold prior to their maturity dates. Those securities must then be valued at their current market values on quarterly financial reports, which makes bank balance sheets subject to greater interest rate risk.

national money markets. As a result, the rural banking system appears well positioned to respond to changes in economic demand for a wide range of borrowers.

While reassuring, the generally healthy financial condition of the rural banking industry may not translate into readily accessible, affordable financing for all credit-worthy rural borrowers. Rural bank performance is often a function of the degree of competition within the local financial markets in which loan decisions are made. One simple indicator of bank market competition is the number of bank organizations operating within rural markets. Because of the presence of branch bank offices and multibank holding company (MBHC) affiliates, measuring bank market competition requires information on the number of independent banking organizations operating within a market rather than the number of legally distinct banks headquartered there.⁵ Despite rapid consolidation within the banking industry nationwide, the average number of competing banks within rural counties has remained remarkably stable over the past 15 years, perhaps because of potential antitrust enforcement by the Department of Justice and bank regulator concerns over the local impacts of mergers.⁶ Still, in 1994, 27 percent of rural counties were served by 2 or fewer banks (including the branches of banks headquartered elsewhere). In contrast, 40 percent of urban counties were served by 10 or more banks. The poorest counties tend to have the least competitive banking markets (see appendix A, table A-2).

The connection between banking market performance (measured as profit or interest rates) and structure (concentration) is well documented. A large body of research, both in banking and the industrial sector, supports this connection (Rhoades, 1995). This relationship is generally attributed to the existence of market power (Berger and Hannan, 1989 and 1994). Research results, that higher prices and profits tend to exist in

more concentrated markets, suggest that market imperfections exist. As summarized by Rhoades, other evidence of market imperfections include:

- high levels of cost inefficiencies among groups of banks of all sizes;
- an observed positive relationship between market profit rates and market growth;
- the tendency of new market entry to reduce market profits especially in rural markets, suggesting that potential competition is insufficient to maintain competitive profit levels and that adjustment to longrun profit levels is slow; and
- the general failure of bank mergers to result in gains in profitability or efficiency.

In addition to the competitiveness of local banking markets, a longstanding issue in many rural areas is the role bank ownership may play in lending decisions. Some rural advocates oppose relaxing restrictions on outside ownership of rural bank offices because they fear that large, nonlocal banks may transfer funds from rural offices for lending elsewhere and that nonlocal managers may lack information needed to evaluate loan applications fairly. Others argue in favor of outside ownership because large banks provide more kinds of financial services, can handle larger loan requests, and are less affected by downturns in the local economy. Nationwide banking industry consolidation trends have made a difference in the ownership of rural banks. About 9 percent of rural counties are served solely by local banking organizations (banks with no offices outside that county), which is down significantly from 1980. Nearly three-fifths of rural counties contain offices from both local and nonlocal banking organizations. To date, available evidence on bank mergers and interstate branching indicates that the availability of credit does not suffer as banks change owners (Rose, 1993; Calem, 1994; Nakamura, 1994; Strahan and Weston, 1996) or that negative effects are limited (Keeton, 1995).

In sum, the rural banking sector appears well positioned to remain the dominant source of credit for creditworthy borrowers. The financial health of the banking sector as a whole, including rural-headquartered banks, is more than adequate to support expanded lending activity. In addition, although banks rely heavily

⁵ Since MBHC affiliates located within the same market can operate like branching networks, they should not be viewed as independent competitors. Almost 31 percent of insured commercial banks belonged to MBHC's at the end of 1995.

⁶ Proposed bank mergers are rarely rejected outright, but it is not unusual for a merged banking firm to spin off certain bank affiliates or bank branches to gain approval for the merger. Also, banks are aware of Justice Department guidelines concerning acceptable changes in local banking market concentration measures. Mergers between two local banks in the same rural county would rarely meet these guidelines.

on local deposits for loanable funds, nonlocal sources of liquidity are increasingly available. However, the lack of bank competition in many rural communities could foster uneven performance by the banking system, with remote rural areas at a potential disadvantage in acquiring equal access to competitively priced credit.

The Farm Credit System

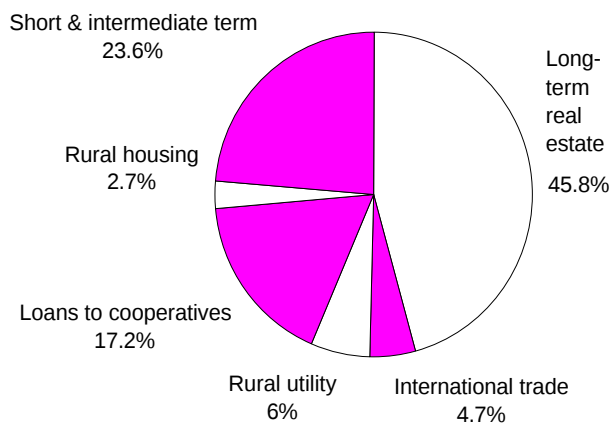
The FCS is a network of federally chartered, borrower-owned cooperatives specializing in agricultural and certain other rural loans. Created in 1916 to provide long-term fixed-rate mortgage loans to farmers (because rural banks were unable or unwilling to risk doing so), the FCS has grown into a major source of agricultural credit and a major competitor in agricultural credit markets. At the end of 1995, the FCS included 8 banks and 228 associations serving every region of the country and providing long- and short-term credit for farmers, farm cooperatives, farm-related businesses, fisheries, rural housing, rural utilities, and agricultural exports. While its lending authorities have been broadened over the years, most FCS loans are for agriculture. At the end of 1995, the FCS loan portfolio amounted to \$59 billion, with roughly half being long-term real estate loans (fig. 3).

Unlike other government-sponsored enterprises (GSE's), which support the housing, college, and farm loan markets through secondary markets, most FCS lending is at the retail level. FCS lenders originate and service the vast majority of the loans they hold. Most loans are made directly to individual farmers for farm production and real estate purchases or to farmer cooperatives providing inputs, marketing, and processing services to farmers. Each FCS bank and association has specific lending authorities and chartered territories. As a result, FCS institutions compete directly with commercial banks and other farm lenders within their service areas (and within the scope of their charters), but they generally do not compete with other FCS institutions.⁷ Most FCS banks also have authority to loan funds to qualifying commercial banks and other financial institutions for short- and intermediate-term

Figure 3

Distribution of FCS loans, 1995

Nearly half of FCS lending is for long-term real estate; housing and rural utility lending is relatively low.



Source: Calculated by ERS from Federal Farm Credit Banks Funding Corporation's Annual Information Statement, December 31, 1995.

farm loans, but few financial institutions use the FCS for this purpose.

Eligible borrowers must purchase FCS stock to obtain loans from FCS lenders. FCS associations in turn purchase stock in the FCS bank with which they are affiliated. The banks act as conduits for the lending associations, providing them with funds raised from the sale of notes and bonds on the national money markets. These securities are backed by "joint and several" liability of each FCS bank. Thus, if any one FCS bank is unable to meet its obligation to bondholders, the other banks are liable to make the required payments. The securities are also commonly viewed by investors as being implicitly guaranteed by the Federal Government, despite the absence of any explicit guarantee. As a result, the FCS enjoys a ready supply of relatively inexpensive funds, borrowed at rates approaching those paid on U.S. Treasury securities.⁸

⁷ The FCS was structured, in part, to offer farmers a competitive alternative to rural banks. Reducing market power of middlemen was a longstanding concern of the populist farmer-cooperative movement when the FCS was created. As cooperatives, with each bank responsible for the obligations of the entire System through its "joint and several" liability, competition within the System generally has been avoided.

⁸ Even when the FCS was facing financial difficulties in 1985, the spread between FCS agency securities and comparable U.S. Treasuries was only 50 to 60 basis points (0.5 to 0.6 percentage points), indicating widespread confidence that the FCS was basically sound and that the Federal Government would not let a GSE fail to make timely payments on its debt (Duncan and Singer, 1992). Currently, the spread between FCS and Treasury securities is 7-15 basis points for 1- to 5-year maturities.

The FCS is a specialized lender with a Federal mandate to serve as a reliable source of competitively priced funds for agricultural and other rural borrowers. This mandate, in conjunction with the FCS cooperative nature and some questionable lending practices, resulted in rapid growth in the 1970's. But when the farm sector experienced severe financial stress in the early to mid-1980's, the FCS contracted rapidly as creditworthy borrowers found cheaper sources of credit and stressed borrowers defaulted on their loans.⁹

The System's finances have since recovered, but as a result of its earlier difficulties, the FCS has become far more selective in its lending.¹⁰ Individual banks and associations retain a great deal of discretion with regard to pricing, loan approval, stock purchase requirements, dividend policies, and the like. To ensure the safety and soundness of FCS institutions, the Farm Credit Administration and the Farm Credit System Insurance Corporation act as regulator and insurer of FCS obligations, respectively. In addition, FCS banks have voluntarily entered into several agreements with each other that provide further incentive for each bank to maintain a strong financial position. In 1995, the System's total loan volume grew by 4.5 percent, its income exceeded \$1 billion for the third year in a row, and it experienced declines in provisions for loan losses and noninterest expenses (fig. 4). Its net interest margin, at approximately 3 percent, remains high enough to sustain earnings (USDA, 1996a).

The FCS is well positioned to respond to increases in economic demand for credit from eligible borrowers. Its status as a GSE continues to provide (off-budget) Federal subsidies and access to an ample and flexible supply of loanable funds. Most FCS institutions hold levels of capital well above regulatory minimums. For activities that the System's various—largely autonomous—institutions are authorized to finance,

competitively priced credit should be available to qualifying borrowers.

Government Programs

A largely private, competitive financial system is essential to attaining sustained economic growth (King and Levine, 1993; Jayaratne and Strahan, 1996). If funds are allocated for projects that are not among the most profitable, capital has been poorly allocated and economic growth rates suffer. Public sector involvement can improve the economic performance of financial markets to the extent that market segmentation is reduced. Federal policies and programs that heighten lender competition, lower transaction costs, or improve information have enhanced financial market efficiency. But direct lending programs operated by the public sector rarely succeed in allocating capital efficiently and are often not intended to do so.¹¹ Rather, as discussed previously, subsidized government credit programs generally address "fairness" concerns.

An efficient, competitive financial market offers buyers of credit services equal opportunities, but even this equality of opportunity may not yield a "socially equitable" allocation of resources. For example, the uneven distribution of education and wealth within the U.S. population creates an uneven distribution of creditworthiness that may be politically unacceptable. Thus, many Government programs exist because of dissatisfaction with the way private, competitive mar-

¹¹ Indeed, one source of financial market failure can arise when too many or too risky loans are made because of Federal subsidies. As Calomiris and Himmelberg (1993) observe:

"Although governments have different (collective) objectives and deeper pockets than private suppliers of credit, they typically do not have better info or better means of detecting and punishing undesirable behavior by borrowers. If private sector credit is scarce because of the high fixed cost (in a physical sense) of establishing intermediaries, government intervention to defray these costs may be beneficial if it improves the allocation of capital. If the shortage of credit is attributable to asymmetric information, and if the government's information is no better than that of private credit suppliers, government loans, guarantees, or loan subsidies may not provide assistance where it is needed most and may crowd out better uses of funds.

"Social costs of government credit programs need to be taken into account as well. In particular, the distribution of funds has been motivated by political, rather than economic, goals (see Aleem, 1985; Braverman and Guasch, 1986). Higher rates of default and the misallocation of credit are not the only disadvantages of throwing money at the problem of rural credit scarcity. Such policies may also destabilize markets and thus make farm ownership even more difficult for worthy borrowers who are denied access to government programs. Carey (1990) argues that the government-subsidized credit boom of the 1970s in the U.S. caused a speculative bubble in the prices of farmland that set the stage for the collapse of land values in the early 80s...."

⁹ The System's practice of charging interest rates for its loans based on the average cost of its operations, combined with a large stock of fixed-rate, noncallable bonds sold at high interest rates, meant that as interest rates declined in the 1980's, the FCS ceased being a low-cost source of farm credit. The System has since adopted marginal cost pricing and has prepaid its high-cost debt, making it a strong competitor for agricultural loans.

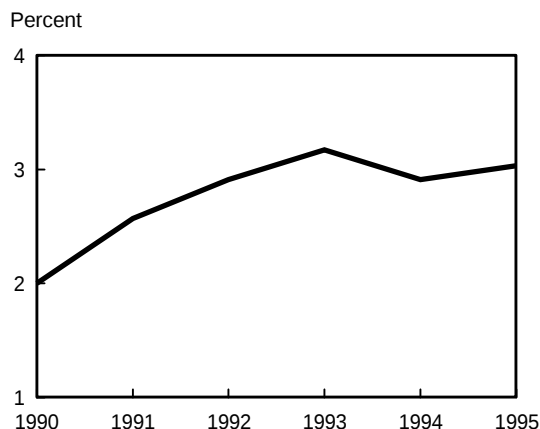
¹⁰ Based on USDA research, farm operators borrowing from the FCS tend to be more financially secure, and FCS debt is concentrated among more established and larger operators. Those operators whose primary lender is the FCS own more land, are more likely to be in higher income brackets, and are older than farmers who borrow from commercial banks or from USDA (Koenig and Dodson, 1995).

Figure 4

Farm Credit System finances, 1990-95

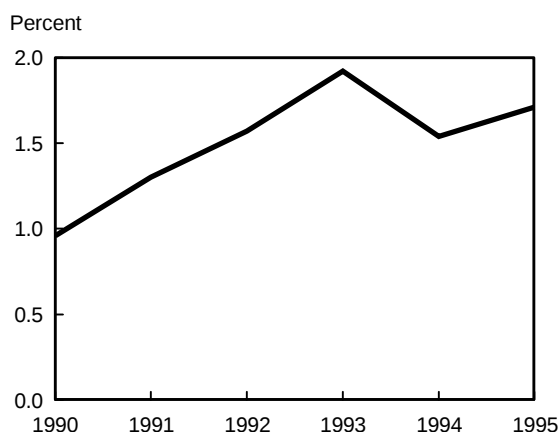
Net interest margins

Net interest margins support sustained growth in earnings



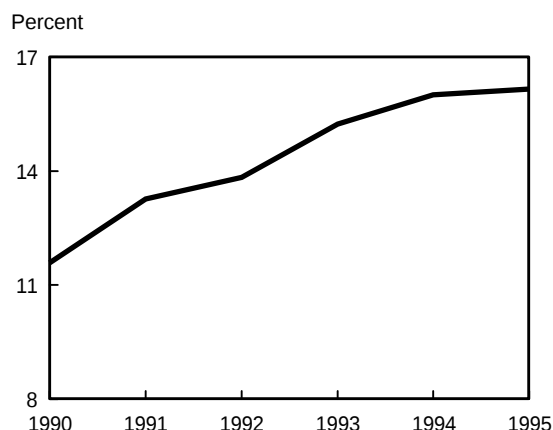
Return on assets

FCS earnings remain strong despite a dip in 1994.



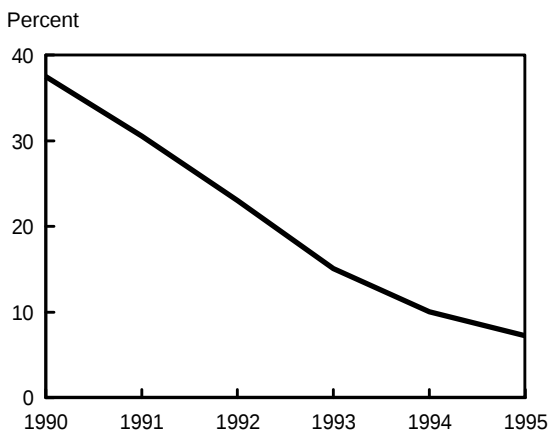
Risk capital/asset ratio

Capital continues to grow as a proportion of FCS assets.



Problem loans as a share of risk capital

Bad loans continue to decline relative to FCS capital.



Source: Calculated by ERS using Federal Farm Credit Banks Funding Corporation, *Annual Information Statements*, 1990-95.

kets allocate capital resources. Concerns over fair treatment of underserved populations underpin many Federal credit assistance programs. Some social fairness concerns, such as nondiscrimination, are consistent with market efficiency. Most, however, are not related to efficiency and require budgetary outlays and slower economic growth to meet program goals. Such interventions involve subsidies (from the government, lenders, or other borrowers) for favored lenders or bor-

rowers, requiring targeted program eligibility rules to allocate credit.

The Federal Government uses a number of different approaches to influence the allocation of credit in the U.S. economy—regulation of financial institutions, tax policies, bankruptcy laws, support for secondary markets, and financial assistance programs all affect credit allocation. This section is concerned with financial assistance programs, which include direct loan and loan

Table 2—Federal grants for economic development, 1994

Rural areas receive slightly less grant money per capita than urban areas; Federal agencies other than USDA provide most of the rural economic development grant funds.

Purpose and source ¹	Share allocated to counties ²	Type of county		
		Urban	Rural	Poverty
	<i>Percent</i>	<i>-----Dollars per capita-----</i>		
Agriculture	66	1.41	2.30	0.88
USDA agencies	89	1.33	1.99	0.88
Other Federal agencies	38	0.08	0.31	0.00
Housing	84	19.29	16.42	32.04
USDA agencies	100	0.13	0.86	1.52
Other Federal agencies	83	19.16	15.56	30.52
Business	96	1.72	1.10	1.37
USDA agencies	100	0.08	0.63	0.70
Other Federal agencies	95	1.64	0.47	0.67
Community development	78	117.85	100.41	99.09
USDA agencies	62	0.65	6.65	8.64
Other Federal agencies	81	117.20	93.76	90.45
All of the above	80	140.27	120.23	133.38
USDA agencies	74	2.19	10.13	11.74
Other Federal agencies	81	138.08	110.10	121.64

¹ The purpose of each Federal program is based on the primary activities funded. For a complete listing of the programs included in each category, see Appendix A, table A-8.

² The percentage of all Federal program spending within the category that is allocated to the county level (and therefore reflected in the per capita figures).

Source: Calculated by ERS from the Census Bureau's Consolidated Federal Funds Report, 1994.

guarantee/insurance programs, but also involve some grant and technical assistance programs. The budgetary costs, contingent liabilities, administrative oversight, and economic impacts of these approaches vary widely, both among approaches, and among programs using the same general approach. Given their number and diversity, this section is concerned mostly with how each program approach can address fairness and efficiency concerns and how funds were allocated in 1994 among geographic areas and borrower groups.

Grant programs. While not credit per se, grants are an obvious substitute for credit in delivering financial resources to spur rural development. Indeed, from an economic efficiency perspective, grants are often superior to credit for dealing with fairness issues. They can provide the subsidies needed to arrive at a “fair” allocation of resources without burdening the recipient with debt repayment obligations.¹² Grants can also help

alleviate credit market inefficiencies related to high transaction costs and provide seed funds for new competitors.¹³ Since grants are not repaid (unless the terms of the grant agreement have been violated), they have an immediate impact on the Federal budget.

Grant programs are most prevalent for public infrastructure and community development projects, but also support the provision of low-income housing and technical assistance. In fiscal 1994, rural areas received roughly \$100 per capita for infrastructure and community development—far more than for any other purpose (table 2). Of all grant funds that were allocat-

¹² Subsidized credit programs are not ideal for aiding low-equity, beginning farmers, for example, because the amount of public assistance that can be provided with any hope of repayment is often inversely related to its need (Dodson, 1996).

¹³ For example, Federal support for revolving loan funds and community development financial institutions is often in the form of grants.

Table 3—Federal direct loans for economic development, 1994*Rural areas receive far more in direct loans per capita than urban areas, largely from USDA agencies.*

Purpose and source ¹	Share allocated to counties ²	Type of county		
		Urban	Rural	Poverty
	<i>Percent</i>	<i>-----Dollars per capita-----</i>		
Agriculture	99	15.08	76.49	129.06
USDA agencies	99	15.08	76.49	129.06
Other Federal agencies	--	--	--	--
Housing	100	6.44	28.50	30.91
USDA agencies ³	100	6.44	28.50	30.91
Other Federal agencies	--	--	--	--
Business	99	19.60	6.50	8.93
USDA agencies	100	0.15	0.82	1.05
Other Federal agencies	99	19.45	5.68	7.88
Community development	100	3.23	29.14	26.55
USDA agencies	100	3.23	29.14	26.55
Other Federal agencies	--	--	--	--
All of the above	99	44.35	140.63	195.45
USDA agencies	99	24.90	134.95	187.57
Other Federal agencies	99	19.45	5.68	7.88

¹ The purpose of each Federal program is based on the primary activities funded. For a complete listing of the programs included in each category, see Appendix A, table A-9.

² The percentage of all Federal program spending within the category that is allocated to the county level (and therefore reflected in the per capita figures).

³ The Consolidated Federal Funds Report combines USDA's direct and guaranteed rural housing loans and reports the total as direct loans.

-- Indicates that no direct loan programs for this purpose were administered by other Federal agencies.

Source: Calculated by ERS from the Census Bureau's Consolidated Federal Funds Report, 1994.

ed to the county level, rural areas received approximately \$120 per capita—about 85 percent of the urban level.

Direct loan programs. Direct loans are those originated and often serviced by a Federal agency. For the past 2 decades, the Government has been reducing its direct lending activities in favor of programs, such as loan guarantees, that encourage greater private sector lending. However, a number of Federal agencies continue to operate direct loan programs for specific borrowers qualifying for subsidized credit, such as victims of natural disasters and limited-resource borrowers. While direct loan programs can require large administrative staffs to ensure that funds are properly targeted, they are appropriate for delivering highly subsidized credit since, like grant programs, they maximize the Government's control over allocation decisions.

Budgetary impacts depend upon the size of explicit subsidies (mainly administrative costs and below-market interest rates) and implicit subsidies (loan losses), but are generally a sizeable fraction of the dollars loaned.

In fiscal 1994, of the \$141 per capita received by rural borrowers through direct loan programs, over 95 percent came from USDA (table 3). Roughly half of USDA's direct loan program funds were disbursed through Commodity Credit Corporation nonrecourse loans to farmers that year, but the Department also operated substantial direct loan programs for infrastructure and housing. Direct loan programs are far less prevalent in other Federal agencies.

Guaranteed/insured loan programs. Loan guarantees and insurance now dominate Federal agency lending

activities. With a loan guarantee or insurance program, the Government leaves the origination and servicing aspects to private lenders, which many believe have comparative advantages over Government agencies in these activities. The guarantee/insurance lowers or completely removes the risk of default losses on loans to qualified borrowers, increasing lenders' willingness to supply them with credit. The fact that the loans are backed by the Federal Government also reduces the amount of capital that lenders are required to hold on outstanding loans and increases their liquidity. The increased liquidity resulting from Federal loan guarantees/insurance may allow participating lenders to make more loans—of all types—than they would otherwise.

Loan guarantee/insurance programs that do not involve explicit interest rate subsidies need not require large administrative staffs, or even annual appropriations, if they are designed to be self-financing. If the basis of the program is that the private sector is not properly evaluating creditworthy loans, then subsidized interest rates should not be necessary; fees and coinsurance can be used to reduce or eliminate taxpayer support. If, however, the basis of the program is that a class of borrowers cannot afford commercial rates of interest, then subsidized interest rates are required, as is an administrative staff to ensure that program beneficiaries meet eligibility criteria. Both self-financing loan programs and guaranteed/insured loans with explicit interest rate subsidies are relatively rare; most guaranteed and insured loan programs fall in the middle, providing implicit subsidies to program participants by shouldering a portion of the program's operating costs. The budgetary impact of guaranteed/insured loan programs depends on how costs are shared between the government, lenders, and borrowers, and upon program eligibility criteria. Typically, initial program outlays are a small fraction of loan volume, but loan losses occasionally increase government costs significantly.¹⁴

With few exceptions, agencies that offer direct loan programs also offer guaranteed loan programs. In 1994, rural areas received over \$197 per capita in federally guaranteed/insured loans—far less than the \$581 per capita received by urban communities (table 4).

¹⁴ For example, a *Wall Street Journal* article claims that the default rate on the Small Business Administration's 7(a) guaranteed loans is expected to reach 17 percent this year, increasing program losses and budgeting outlays (Ho, 1996).

Housing accounted for two-thirds of the rural allocation, with the remainder going mostly to farms and other rural businesses. Only about 15 percent of the guaranteed/insured loan funds going to rural borrowers was from USDA programs.

Technical assistance. In addition to financial support, various Federal agencies also provide technical assistance directly to farmers, businesses, and communities. Technical assistance helps borrowers plan and implement economically viable development projects. For example, the USDA's Extension Service provides technical assistance to farmers and rural businesses and communities throughout the Nation, through university extension staff and county extension agents. The U.S. Department of Commerce's Economic Development Administration (EDA) provides technical and business assistance to small- and medium-size manufacturers (those whose plants have fewer than 500 employees) through its Manufacturing Extension Partnership program, which operates in over 300 locations nationwide. The Small Business Administration (SBA) helps small businesses put together business plans and provides other such assistance to small businesses through its Small Business Development Centers.¹⁵ Technical assistance is also provided by supervised credit programs administered by Federal agencies or with Federal funds.

Technical assistance is unique as a credit-enhancement technique since it fundamentally improves the quality of credit demand rather than its supply. Credit (unless it is merely a disguised income transfer) requires repayment. In order to qualify for commercial credit, households, businesses, and governments must demonstrate the potential to satisfactorily make loan payments on a timely basis. Through its technical assistance programs, the Federal Government improves the ability of recipients to carefully manage their household, business, or public budgets, thereby improving their qualifications for commercial loans. The supply of credit is not altered *per se*, but its availability to underserved populations may be.

¹⁵ In addition to technical assistance provided directly by Federal agencies, Federal grant programs support private technical assistance providers. USDA, EDA, the Environmental Protection Agency, and SBA all operate technical assistance grant programs to improve the technical and managerial skills of a wide range of borrowers. While many of these programs are national in scope, rural areas tend to benefit disproportionately from their use.

Table 4—Federal guaranteed/insured loans for economic development, 1994*Rural areas receive far fewer guaranteed/insured loans per capita than urban areas; housing assistance predominates.*

Purpose and source ¹	Share allocated to counties ²	Urban	Type of county Rural	Poverty
	<i>Percent</i>		<i>-----Dollars per capita-----</i>	
Agriculture	100	1.68	28.17	34.28
USDA agencies	100	1.68	28.17	34.28
Other Federal agencies	--	--	--	--
Housing	99	547.03	132.99	72.68
USDA agencies ³	--	--	--	--
Other Federal agencies	99	547.03	132.99	72.68
Business	83	32.55	35.78	28.46
USDA agencies	100	0.48	2.89	2.45
Other Federal agencies	83	32.07	32.89	26.01
Community development	100	0.08	0.28	0.10
USDA agencies	100	0.08	0.28	0.10
Other Federal agencies	--	--	--	--
All of the above	99	581.34	197.22	135.52
USDA agencies	100	2.24	31.34	36.83
Other Federal agencies	99	579.10	165.88	98.69

¹ The purpose of each Federal program is based on the primary activities funded. For a complete listing of the programs included in each category, see Appendix A, table A-10.

² The percentage of all Federal program spending within the category that is allocated to the county level (and therefore reflected in the per capita figures).

³ The Consolidated Federal Funds Report combines USDA's direct and guaranteed rural housing loans and reports the total as direct loans.

-- Indicates that no guaranteed or insured loan programs for this purpose were active in fiscal 1994.

Source: Calculated by ERS from the Census Bureau's Consolidated Federal Funds Report, 1994.

The diversity of clientele, the importance of individual program rules and administrative procedures, and the changing budget authorities of Federal credit assistance programs make blanket statements about their ability to satisfy the rural demand for program funds meaningless. But then, satisfaction of demand is not the goal of most subsidized programs. As has already been stated, if unrestricted, demand for subsidized assistance will always exceed supply; only by restricting program eligibility can subsidized credit programs avoid being hopelessly oversubscribed. Attempts to balance the Federal budget have reduced the size of grant and subsidized credit programs and may raise questions about the "fairness" of credit allocations, but as a general rule, rural credit market efficiency is not likely to be adversely affected. (For a discussion of the potential rural impacts of recent Federal spending and policy

decisions, see USDA's *Rural Conditions and Trends: Federal Programs*, 1996b.) On the other hand, Federal programs aimed at improving the efficiency of rural financial markets, such as loan guarantee, insurance, and technical assistance programs, face and satisfy economic demand if they are market-based. Whether these programs are efficiently administered and allowed to respond to market changes is beyond the scope of this study.

Conclusion

Congress requested that this study analyze rural demand for credit from the Farm Credit System, the U.S. banking system, the U.S. Department of Agriculture, and other Federal agencies, the ability of each of these credit providers to meet the demand, and

the extent to which they provide loans to satisfy the demand. This report has examined the markets these lender groups serve, their current financial strengths and weaknesses, and factors affecting their abilities to respond to changes in economic demand for credit. The level of demand for credit is not addressed here for three primary reasons. First, as competitors, the demand facing FCS lenders and commercial banks is not independent where both types of institutions are chartered to make particular types of loans. Second, government-subsidized credit programs are not generally intended to meet economic demand. And finally, reliable data on economic demand independent of supply are not available.

Commercial banks in rural areas and FCS lenders are both generally financially strong and able to respond to increases in economic demand. Both groups of lenders have increased their lending in recent years and claim to be prepared to meet future demand for commercial credit. Despite this observation, substantial evidence

exists that many rural credit markets remain imperfectly competitive (fig. 5). These imperfections may result in operating inefficiencies among some rural lenders, with higher credit costs or tighter loan approval standards possible for some rural borrowers. However, no attempt has been made to evaluate the financial status, operating efficiency, or competitive performance of specific lenders or specific rural credit markets, so the number and geographic location of affected borrowers is unknown.

The effectiveness of most federally subsidized credit programs does not depend on their ability to satisfy demand but rather is a function of how cost-effectively they satisfy their public purpose. Judging how “fair” the results are requires a set of value judgments about who does and does not deserve credit and how much subsidy society is willing to provide. These judgments are best addressed through the political decisionmaking process and have not been evaluated here.

Figure 5

Rural counties served by fewer than 3 banking firms

Sparsely populated and poor counties have few competing firms.

