Renting Money: Another Increasing Cost for Farmers

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Significant attention has been given to the increasing costs of fuel, fertilizers, chemicals, seed, and cash rent on Illinois farms. Rising interest rates, or the cost of “renting” money, have also lowered profit margins for Illinois farms. On May 10th the Federal Open Market Committee of the Federal Reserve decided to raise its target for the federal funds rate by 25 basis points to 5%. This is the fifteen consecutive rate increase dating back to June 2004. The federal funds rate is closely linked to the interest rates of short-term loans.

The primary justifications of the increases have been to address inflation risks and attempt to achieve a balance of sustainable economic growth and price stability. The Fed’s Open Market Committee also releases general statements regarding their current outlook. A portion of their statement on May 10, 2006 said “The Committee judges that some further policy firming may yet be needed to address inflation risks but emphasizes that the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information.” This statement indicates that the Fed may not be done “yet” and some uncertainty exists regarding the timing of potential future increases. These statements and other economic forecasts suggest that it may be unlikely to expect interest rate declines in the near term.

Interest rates on farm loans have certainly not been immune to these increases. Currently, the average interest rate on operating loans for commercial banks in the Chicago Federal Reserve district exceeds 8%. These rates are 100 to 150 basis points higher than one year ago. In percentage terms the increase is 18-25% over operating rates in 2005. Similar, but smaller increases are occurring on farm real estate loans. The average interest rate on farm real estate loans by commercial banks at the end of 2005 was 7.25% compared to 6.39% at the end of 2004, or a 13% increase.

An increase in interest costs of 15% would result in a decrease in net farm income of approximately $2,500 ($3 per acre) for the average Illinois FBFM farm. The actual increase in 2006 will likely be higher due to the need to borrow additional resources to finance the higher input costs.

The impact of the interest rate increase can also be illustrated through the increased costs of purchasing farmland. For example, an increase in interest rates from 6.5% to 8.0% on 80 acres of farmland priced at $3,500 with a 35% down payment on a 20-year loan would result in annual payments of approximately $19,000 or an increase of $2,200 ($27.50 per acre) for the same loan at a 6.5% interest rate.
As you budget for 2006 and 2007, it is advisable to review your loan terms to avoid cash flow surprises resulting from increases in interest rates. Some variable or adjustable rate loans change at periodic intervals as national rates changes. Other loan agreements may be fixed for the life of the loan. A helpful guide for understanding loan terms “A Farmers Guide to Agricultural Credit” can be found in the finance section of farmdoc (www.farmdoc.uiuc.edu).