FINANCING AGRICULTURE IN A PERIOD OF STRESS

by

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The U.S. economy is generally prosperous and healthy but the agricultural sector continues to languish in a deep recession that began in 1981. Most of the nonfarm sectors are characterized by high profts, and low rates of unemployment and inflation. Persistent high real interest rates and a worrisome federal budget deficit are the only clouds in this otherwise bright picture, and while these problems have received a lot of press, they really do not seem to be directly affecting enough people to mobilize a meaningful response in Washington. In this paper, I will review the evidence on financially stressed farmers, review policy proposals and explore solutions.

Incidence of Financial Stress

Financial stress can be defined as a perceived inability to meet near- and longer term cash flow commitments. Current financial stress affects those farmers and farm lenders who entered into contractual agreements prior to 1981 on the expectation that farm incomes and asset values would continue to rise, and that real interest rates would remain low. None of these expectations were

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fulfilled. Farm incomes have fallen, the nominal value of farm assets in Ohio has receeded, by more than 50 percent to its 1976 level and real interest rates remain high. Moreover, no one is forecasting any immediate relief.

The U.S. Situation

A March 1985, USDA report continues to be the most comprehensive analysis of farm financial stress. This report focused on the plight of 679,000 "family-sized commercial farms," those with annual sales of $50,000 to $500,000. As of January 1985:

---6.3 pecent (43,000) of these farms, owing 9.3 percent of total farm debt were technically insolvent (debt/asset ratios over 100 percent)

---7.4 percent (50,000) farms, owing 11.1 percent of the debt, were moving rapidly toward insolvency (debt/asset ratios 70 to 100 percent)

---20 percent (136,000) farms, owing 25.9 percent of the debt had serious financial problems (debt/asset ratios 40 to 70 percent), but will be able to survive a few more unfavorable years.

---66.3 percent (450,000) farms, owing 17.9 percent of all farm debt had no apparent financial problems (debt/asset ratios under 40%).

To summarize these stark conclusions, one-third of the nation's family-sized commercial farms have serious to extreme financial problems, and these farmers owe nearly half of the more than $200 billion total farm debt. If all U.S. census farms are included, about one-fifth have debt/asset ratios over 40 percent and these farmers owe nearly three-fifths of the total farm debt.

The Ohio Situation

In most respects, the farm financial picture in Ohio mirrors the national situation fairly closely. A March 1985 survey revealed that among Ohio's approximately 22,000 family-sized commercial farms (gross sales exceeding $40,000 annually)

---10% (2,200) were having extreme financial problems (debt/ asset ratios above 70%)

---19% (4,200) were having serious financial difficulties (debt/asset ratios of 40 to 70%)

---71% (15,600) had no apparent financial problesm (debt/asset ratios under 40%). When all of Ohio's 90,000 census farms are included:

---24% of all Ohio farmers with nonreal estate debt, and 16 percent of those with real estate loans were delinquent with their loan payments

---3% (2,700) were involved in some type of legal action in connection with delinquent loans.

---Nearly half of all Ohio farmers under age 45 have debt/asset ratios above 40%, compared to 16 percent of those 45-64 and 3 percent of those 65 and over.

---Ohio's larger farms are experiencing more stress. The proportion of farms with debt/asset ratios above 40 percent ranges from 12% of farms under 100 acres to 59% of farms with 750-1000 acres.

---The proportion of all Ohio farmers with debt/asset ratios above 40 percent varies from a low of about 20 percent in the East and Southeast parts of the state to a high of nearly 40 percent in the Southwest.

Farm Lender Situations

Nearly $120 billion of the over $200 billion in total U.S. farm debt is owed by financially troubled farmers (debt/asset ratios over 40%), and $40 billion of this is owed by farmers with extreme financial problems (debt/asset ratios over 70 percent).

To understand the impact of farm financial stress on farm lenders, one needs to recognize the following:

---lenders themselves are very highly leveraged, with debt/asset ratios typically ranging from 90 to 95 percent. Their ability to absorb loan losses is very limited.

---Farm loan losses in each of the past three years have exceeded the cumulative total losses in the past half century. Few lenders were equipped by training or experience to deal with the recent onslought of delinquencies, foreclosures, bankruptcies, write-offs, and other loan workout situations.

---Nonfarm loans are generally performing well,so the incidence of lenders' problems is directly proportional to the degree to which they specialize in farm lending.

---Farm debt constitutes only 3 percent of total private and public sector debt in the U.S. It is very unlikely that the worsening farm credit problem will lead to a total collapse of our financial system.

Farm loan losses have been more than some farm lenders could bear. Of the 95 U.S. commercial bank failures in the first three quarters of 1985, 48 were agricultural banks (with farm loans exceeding 17 percent of total loans). More than 400 other agricultural banks had delinquent loan volumes that exceeded their equity capital--an early indicator of eventual failure.

To date, commercial bank failures have been limited primarily to small, independent, rural banks in the western Cornbelt. The largest volume of commercial bank farm loan losses has been reported in California, but these losses are being easily absorbed by large, statewide branch banks with diversified loan portfolios. The same situation applies to Ohio's larger banks, and the impact of farm credit problems on smaller banks in Ohio is buffered by our diversified economy.

The plight of the Farm Credit System (FCS) lenders has been regularly reported in the Wall Street Journal throughout 1985. Approximately $11 billion (15 percent) of their combined $74 billion ag. loan portfolio is classified as "nonperforming" and by their estimate loan chargeoffs of $3 billion are possible over the next three years. The system has received an emergency credit line from the federal government to preserve member capital and to meet cash flow obligations.

The FCS lender's problems have been exacerbated by interest rate trends. The decline in interest rates in 1985 caused a more rapid decline in lending rates at commercial banks because they use marginal cost pricing while the FCS uses a less responsive average cost pricing formula. FCS lending rates were also affected by increased spreads to cover loan losses, and by the sharp increase in funding costs following the announcement that government assistance would be needed. The differential between FCS and Treasury issues increased to over 100 basis points after the system requested assistance in

September, 1985. These loan pricing problems have caused an as yet unknown loss in loan volume to competitors. Generally, only the more creditworthy FCS members have been in a position to change lenders, so there has likely been a further erosion in FCS loan portfolio quality.

Consistent with its role as the farm lender of last resort, the Farmers Home Administration (FmHA) has experienced increased lending and worsening delinquency problems in recent years. By mid-1985, 39 percent of FmHA borrowers nationwide (holding 27 percent of FmHA loan volume) were classified as delinquent. Five years ago, only 13 percent of FmHA borrowers (3.8% of the loan volume) were delinquent. This growth in FmHA lending activity and loan servicing was probably not accompanied by a proportionate increase in budget, although there seems to be less publicity about FmHA backlogs in 1985 than in previous years.

Comparatively little information is available on the situation of other farm lenders--life insurance companies, merchants, dealers and individuals. There is little doubt that these other lenders have also experienced large increases in loan servicing costs and loan losses.

Impacts on Rural Communities

The effects of the loss of sizeable numbers of farmers and substantially lower incomes for those who remain have spilled over into businesses and institutions in rural communities. A recent Iowa study identified the following impacts:

---Reduced sales, profits and asset values and increased trade credit losses for agribusiness firms

---Dramatic declines in retail sales and a sharp increase in small business failures

---Outmigration and population losses

---A declining tax base.

This study also noted that so far, the rural economy has been able to absorb a surprisingly high proportion of displaced farmers. Moreover, the current farm recession has probably only accelerated long term economic and demographic changes in rural communities. However, the capacity of many rural communities to continue to absorb displaced farmers is limited. If the recession continues, we can expect more population losses, further declines in retail sales, more difficulties for agribusiness firms, declining school enrollments and disruption of other community organizations and institutions.

Problems and Solutions

U.S. agriculture is clearly an industry with excess capacity--too much land, machinery and labor relative to domestic and foreign demand. The downsizing that is taking place is reflected in the painful financial adjustments referred to earlier.

Excess Capacity

U.S. farmers responded dramatically in response to perceived world-wide food shortages in the 1970s.

—harvested acreage of feed and food grains increased from 130 million acres in 1970 to 171 million acres in 1981. By 1984, harvested acreage had been reduced to 158 million acres, but further reductions, 25 to 30 million acres by some estimates, are needed.

—the excess capacity problem is compounded by continued advances in productivity. Recent developments in biotechnology promise further increases in productivity growth.

Slow Demand Growth

—The U.S. population growth rate is low and there are ongoing secular changes in U.S. food consumption patterns--less red meat and dairy products, fewer calories and more fruits, vegetables, poultry and seafood. The demand for livestock feed grains will be stagnant.

--Export demand is down. In many developing countries, lower economic growth rates and burdensome debt loads have reduced their effective demand for U.S. agricultural exports. Moreover, there is increased export competition from countries such as Agentina, Australia, Canada and the EEC. Some former food importing countries, China, Thailand, India, for example, are now net food exporters.

High Debt Carrying Costs

--Agriculture is a capital intensive industry and U.S. farmers borrowed heavily in the 1970s when asset values were rising and real interest rates were low. Now, asset values are falling and real interest rates tripled--from about 3 percent to nearly 9 percent between 1979 and 1984.

--Higher interest rates have raised debt servicing costs, increased production costs and supported a strong U.S. dollar which in turn has stifled farm exports.

Declining Farm Asset Values

--Nationwide, farm land values have fallen more than 18 percent since their 1982 peak. In some areas land values have fallen as much as 60 percent.

--Declining asset values are a necessary part of the downsizing of American agriculture. Farm asset values will continue to decline until current and expected returns to investments in agriculture are competitive with other investments.

--The financial condition of highly leveraged farming operations will continue to deteriorate, a growing number will be forced out of business and farm lenders will continue to experience historically high levels of loan losses.

Remedial Policies

National Economic Policies

It is generally agreed that agriculture would benefit from a lower federal budget deficit and less restrictive monetary policies. These in turn would reduce real interest rates. Lower real interest rates would:

--reduce farm debt servicing costs

--support farm asset values

--lower the value of the dollar, giving increased competitiveness for U.S. farmers in export markets

--improve the financial position of debtor nations and strengthen their effective demand for our food exports.

Federal tax policies, as they affect agriculture, also need to be re-examined. Tax advantages such as cash basis accounting and development expense write-offs are used by farmers, and by growing numbers of nonfarmers to shelter off farm income. Tax advantages have probably stimulated overinvestment in agriculture. The resulting overproduction has contributed to downward pressure on commodity prices.

Ironically, the tax laws work to the disadvantage of financially pressed farmers who are forced to liquidate assets. Liquidating assets may appear to be a solution to reduce debt loads and improve cash flows; however, there are several tax disincentives to this strategy, including depreciation and investment credit recapture, capital gains tax, alternative minimum tax, acceleration of estate tax installment obligations and estate tax use valuation recapture. These provisions apply in voluntary as well as forced liquidations, and many farmers going through foreclosures and bankruptcies potentially face substantial federal income tax liabilities.

Agricultural Policy

National economic policies probably have a greater impact on agriculture than do agricultural policies *per se*. Nevertheless, agricultural policy changes are needed to balance supply and demand and to regain competitiveness in world markets. These include:

—A transition to a more market-oriented price policy

—Direct government payments to replace cash receipts lost through lower commodity prices to ease the transition

—Remove fragile land from production

Other National Policies

Given a mature domestic market and continued productivity growth, agriculture's future fortunes will depend on expanded export markets. Toward this end the following policies have been recommended.

—-A more aggressive trade policy, including elimination of nontariff barriers, increased export credits and credit guarantees and long-term food-aid programs

---Value-added export initiatives. Increased export sales of processed or prepackaged products would help to stabilize demand and increase domestic job formation.

---Demand growth initiatives in low and middle income developing countries where population growth rates and income elasticities are high.

---Strategic growth initiatives in the form of long-term aid to stimulate economic development in low income countries with strong potential demand for our agricultural exports.

Credit Policy

Farm credit problems are a symptom of a more deeply rooted farm income problem. Nevertheless, farm credit problems are real and highly visible. Thousands of farmers cannot meet scheduled loan payments, and hundreds of agricultural lending institutions are failing. As a result, farm credit policies are emerging at both the state and federal levels, and as the farm recession continues, more policies will be forthcoming.

The rationale for special credit policies is that we need to "buy time" for financially pressed farmers and lenders. Help is justified, it is argued, because many U.S. farmers are innocent victims of "bad" fiscal, monetary and agricultural policies. Even if needed changes in national economic, agricultural, export and other policies were implemented now, there would be only a gradual, long-term recovery in agriculture. Interim credit policies are needed now to stabilize farm asset values, to slow the exodus of financially stressed operators and to preserve the agricultural credit delivery system. To achieve these objectives, the following policies/programs have been implemented or proposed:

--An "Agricultural Credit Corporation" or "Agricultural Conservation Corporation"—a temporary government entity that would hold delinquent loans and farm assets with unduly depressed values until prosperity is restored.

--Lower interest rates through federal and state programs and agencies such as FmHA limited resource loans, interest buy downs, linked deposits, Aggie bonds, etc.

—Foreclosure moratoria, credit mediation, Ch. 11 Bankruptcy and other legal approaches to delay forced liquidation and exit.

—Direct government aid for failing financial institutions to reduce lending costs and stabilize financial markets.

—More government loan guarantees on farm loans, generally accompanied by writedowns or setasides.

Worthy intentions notwithstanding, these federal and state credit policies are likely to fall far short of solving the farm credit problem. The problem is simply beyond the scope of anything other than massive amounts of government aid. Nearly $40 billion of the nation's total farm debt is owed by farmers who are technically insolvent, or moving rapidly toward insolvency. Corresponding data for Ohio indicate that about $1 billion in farm debt is owed by farmers who are technically insolvent, or nearly so. Loan losses on these farms could amount to as much as $20 billion nationwide ($500 million in Ohio) as these severely stressed operations are restructured and/or liquidated over the next several years.

Recommendations

Policy deliberations should focus on the farm income problem and not merely the symptom, the farm credit problem. The farm income problem is largely a national problem that requires national policy responses. The citizens of Ohio must support constructive fiscal, monetary and other national policies needed to restore economic viability to our agricultural sector. Policy deliberations should also focus on two groups of farmers—those who can survive, and those who cannot. Most family-sized commercial farmers who are technically insolvent, or nearly so will be forced to leave agriculture, sooner or later. These people need relocation benefits, retraining, counseling, legal guidance and other support services to ease the financial and personal problems associated with this transition. A legal process for addressing these situations exists. Foreclosure moratoria would merely forestall the inevitable, usually at the expense of both borrowers and creditors.

Most farmers will survive the 1980s recession, but many in this group need education and training to develop the managerial skills needed to survive and grow in an uncertain business environment. These skills include record keeping, financial analysis, commodity marketing and risk management.

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