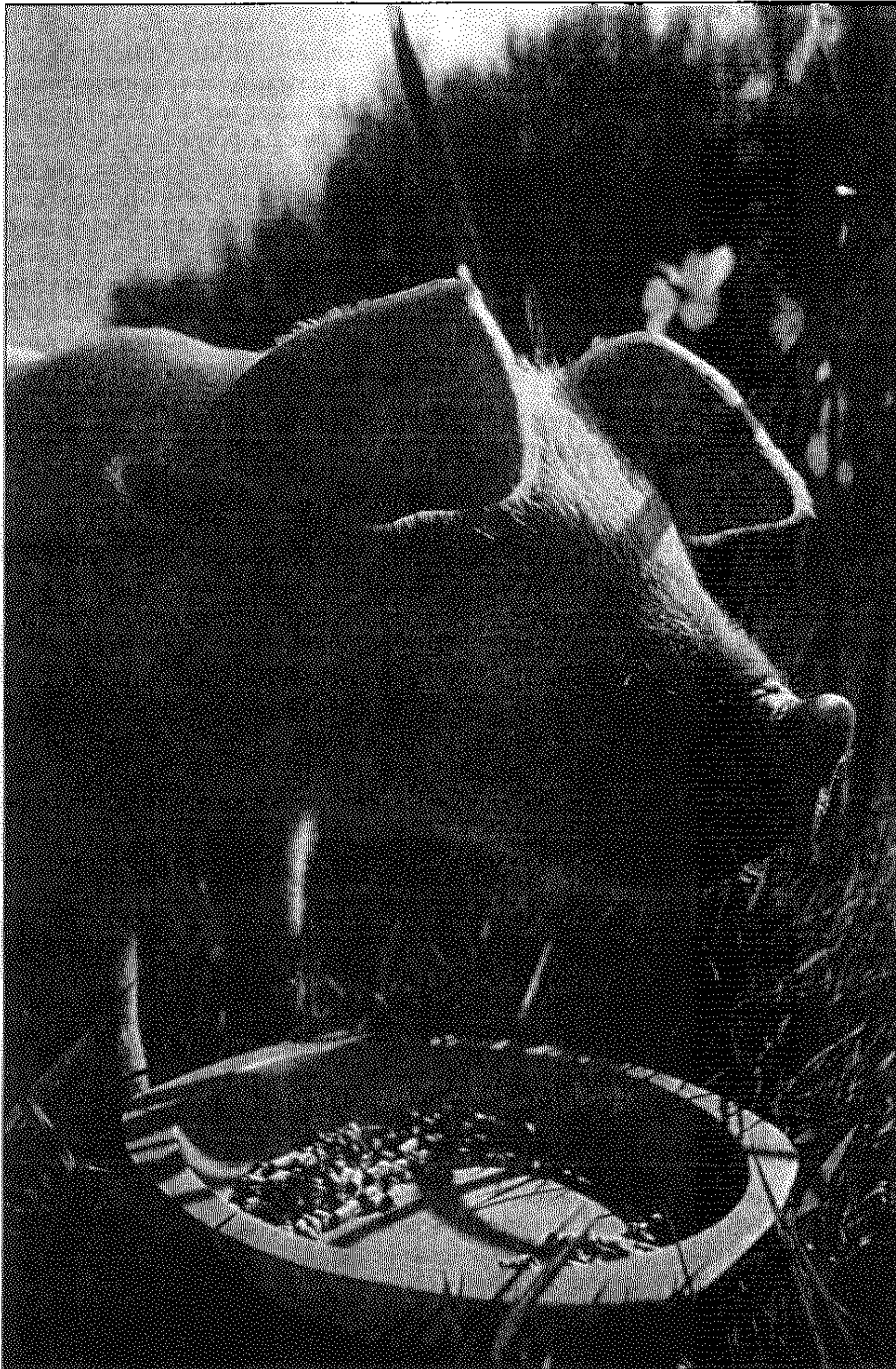
Good times for ag



The Farm Credit System and future. Bankers had best keep

In 1990, I co-authored a report, titled "The Farm Credit System: Reckless Lender to Rural America," which explained how the Farm Credit System (FCS) in large part caused the farm crisis of the 1980s. Since 1990, financial conditions have improved enormously in America's ag sector. However, some financial warning signs are starting to flash in rural America to which bankers and farmers need to pay heed.

The underlying cause of the last farm crisis was extremely low real interest rates which fueled the farm lending boom of the 1970s. Using plentiful, cheap credit, farmers and investors bid up the value of farmland, creating a classic speculative bubble. During those highly inflationary years, the *real* or inflation-adjusted value of farmland doubled, as Figure 1 illustrates. However, the record high interest rates of the early 1980s popped that bubble. Farmland prices then collapsed, bankrupting many farmers and approximately 300 farm banks.

The Federal Reserve was the primary culprit in driving real interest rates too low in the late 1960s and 1970s. While the Fed's strongest influence today is over short-term rates, the entire interest rate yield curve followed the Fed into extreme-

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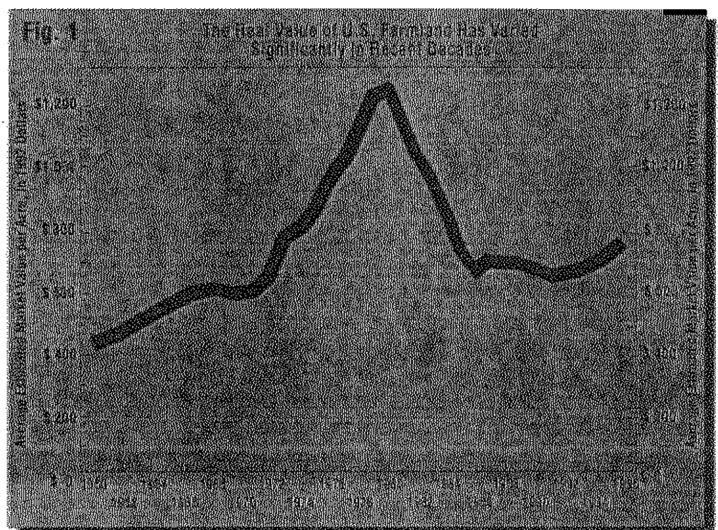
Will they last?

the Fed hold two of the bigger keys to farming's
a close watch on the FCS in particular

ly low and at times negative real interest rate territory during the 1970s. Borrowing to buy tangible assets, such as farmland, became a no-brainer, at least for a time.

The FCS, though, greatly magnified the low interest rate problem by basing its rates on its *average* cost of funds, rather than its marginal cost, and by issuing non-callable instead of callable debt. Worse, in 1971, Congress greatly liberalized the FCS's lending limit by raising it from 65% of farmland's agricultural or income-producing value to 85% of its market value. The FCS immediately went on a lending binge that inflated the farmland bubble. Outstanding FCS loans *quadrupled* from 1971 to 1980 before peaking at $69.2 billion in 1982. While some ag banks also got caught up in the farmland lending boom (bank lending on farm real estate doubled from $4.2 billion in 1971 to $8.6 billion in 1980), the FCS was the driving force behind the boom.

The cash flow crisis that hit farming in the early 1980s, largely caused by record high interest rates, triggered a massive disinvestment by farmers in their machinery and equipment. This cutback forced many farm equipment manufacturers and dealers to close or sharply trim their operations, which worsened economic conditions in rural America.



The pace of strengthening has slowed

The financial condition of farmers generally is much improved from the mid-1980s, but the pace of balance sheet strengthening has slowed in recent years. On the plus side, the debt-to-asset ratio for farmers and ranchers dropped from a high of 23.0% in 1985 to 16.5% in 1989 and then to an estimated 14.6% for 1997. Farm leverage, now approximately where it was in the early 1960s, is basically healthy.

This reduction in leverage has occurred in part because farmers substantially trimmed their farm-related borrowings from a peak of $194 billion in 1984 to $137 billion in 1990. Since then, though, farm debt has grown by about $25 billion, reaching an estimated $162 billion for 1997. Ten billion of that increase was in real-estate borrowing with the remaining $15 billion in non-real estate borrowing.

Lower debt levels, coupled with declining interest rates, steadily improved the ability of farmers to service their debt, until 1994, when the "times interest earned" ratio hit 5.7. Due to rising debt levels, that ratio has declined somewhat, sliding to 4.9 in 1997.

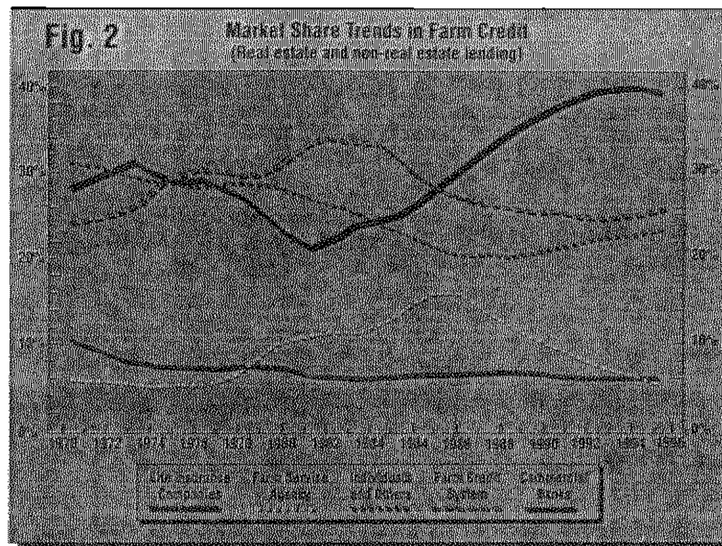
Farm balance sheets have strengthened since 1990 largely because of increases in the value of real estate, which has started to rise above real values of the late 1960s

However, there is some not-so-good news on the ag front. Because of increased farm debt, farm balance sheets have strengthened since 1990 largely because of increases in the market value of farm real estate. As Figure 1 shows, on a real basis, the value of the average acre of farmland has started to rise significantly above the real farmland values of the late 1960s and early 1970s, which rais-

es three related questions:

1. How much more can farmland prices rise, in real terms?
2. Will future increases in farmland values be sustainable?
3. Are farmers who have increased their real estate-related debt betting too much on a continuing rise in farmland values?

The estimated market value of farming's non-real estate assets has held quite steady in recent years within the $220-$230 billion range, which suggests improved equipment utilization and better inventory management. However, the ratio of non-real estate debt to non-real estate farm assets rose from 29% in 1990 to 34% in 1997. This piece of the farm debt picture may even be worse if farmers have significantly increased their credit card debt in recent years.



FCS regains momentum

The FCS has clearly recovered in all regards from its financial problems in the 1980s. Its ratio of total capital, including its insurance reserve, equaled 14.7% of total FCS assets as of September 30, 1997, up from 9.2% at the end of 1991 even though its assets have grown by 23% since 1991. Almost 83% of FCS's capital consists of retained earnings and its insurance reserve; therefore, much of its capital is effectively locked into its balance sheet. FCS capital essentially represents an interest-free source of funding, which gives FCS the ability to cut its interest rates to steal lending business from commercial banks. However, widespread rate-cutting is not yet evident, at least in FCS's earnings

After losing market share for quite a few years, FCS started regaining share in 1996, largely in the non-real estate lending area. According to Agriculture Department estimates, commercial banks' share of total farm lending dropped slightly from 39.8% at the end of 1995 to 39.4% at the end of 1997 while FCS's share for the same period edged up from 24.8% to 25.7% (Figure 2).

Commercial banking has fully recovered from the ag crisis and has increased its lending to the farm sector by $22 billion, or more than 50%, over the last decade. An increasing number of ag banks, though, have experienced difficulty in funding their loan demand. However, interstate branching and banking consolidation are creating a major structural realignment within the banking industry that will significantly affect how credit is delivered in the ag sector. In particular, because of their size and diversity of funding sources, larger banks probably will increase their ag lending at the expense of smaller banks.

Short-term rural outlook

The phase-out of government crop price supports over the next six years will eliminate a source of income that, on average, has accounted for about one-sixth of net farm income in recent years. The 1997 income number suggests that the first year of "freedom to farm" has not been the disaster that some feared.

According to the Agriculture Department's Economic Research Service (ERS), net farm income in 1997 should have hit about $46 billion, down from the 1996 record of $52 billion, but in line with the 1990-96 average.

Despite the increased funding difficulties of many smaller ag banks and strong loan demand, farm credit conditions are not particularly tight. ERS predicts that competition for quality loans will continue to intensify. This heightened lending competition reflects a trend seen throughout the U.S. economy today.

In sum, despite the phaseout of government price supports, the uncertainties arising from a transition to greater planting flexibility, a slight rise in farm debt burdens, and farmland prices that may have risen too high, American agriculture is in as good a shape as it has been for a generation or more.

Another blowup?

The underlying cause of another farmland bubble most likely will be below-market interest rates. Fortunately, the bond market, having been snookered by the Fed into accepting excessively low real rates in the 1970s, learned its lesson and did not fall into the same trap in 1992 and 1993 when the Fed again pulled real short-term rates into extremely low and even negative territory. In effect, during the early 1990s, the bond market saved the United States from a repeat of the 1970s' inflation.

Another round of reckless lending by the FCS, though, could fuel another farmland bubble. Although it has long since abandoned average-cost-of-funds pricing, the FCS still possesses the liberalized lending limit which Congress so unwisely granted it in 1971. Additionally, the Farm Credit System's cost-free retained earnings give it a growing potential to engage in a destructive price war with commercial banks that could, as a side effect, trigger overlending on farm real estate.

Crop and livestock disasters also could create problems in the ag sector. However, given the geographical spread of U.S. agriculture, its tremendous diversity, and the greater planting flexibility farmers now have, it is unlikely that natural disasters will cause widespread credit problems comparable to what American agriculture suffered in the 1980s, provided that farmers continue to maintain conservative leverage ratios.

Excessively generous financing for the buyout of America's increasingly older farmers could create debt servicing problems for buyers, particularly overleveraged young farmers. However, this inevitable buyout problem may create some interesting

opportunities for prudently financing long-term investors in farmland.

Preventing a repeat of the '80s

Farmers, bankers, their trade associations, and others need to closely monitor financial conditions in the farm sector to prevent or reverse future public policy missteps that could cause a repeat of the 1970s and 1980s. The following are conditions to watch.

First, Fed monetary policy must be watched closely, particularly any actions that would drive interest rates too low or too high. Fortunately, the financial markets are exerting increasing influence over interest rates. Once the markets understand that the Fed cannot enforce its interest rate signals, then the markets will set all interest rates, which will eliminate mispriced interest as a threat to both the farm sector and the entire economy.

Second, the FCS must be watched constantly for future missteps for which it is still quite capable. Specific actions to keep the FCS in line include:

- Blowing the whistle to Congress if FCS lending practices become excessively liberalized or its credit quality starts to decline.
- Monitoring FCS earnings closely to ensure that it is not using its substantial cost-free retained earnings to engage in systematic underpricing. This effort would be enhanced if the FCS was stripped of its excess retained earnings.
- Aggressively objecting to new powers for the FCS.
- Encouraging lending units within the FCS to privatize themselves. America no longer needs the FCS because the restrictions on bank branching and real estate lending that fostered its creation in 1916 no longer exist. Today, commercial banks and other private sector lenders can fully meet all of rural America's financing needs.

Politically, the banking industry needs to maintain close, continuing contact with the appropriate congressional committees to ensure that nothing bad politically happens to rural America, specifically in the credit arena.

Finally, the banking industry needs to play a key role, as credit suppliers and otherwise, in promoting greater economic diversity in rural America. Fortunately, electronic technology is stimulating that diversity.

In sum, the likelihood that rural America will blow up again is extremely low, *provided* that the financial markets continue to dominate credit pricing, the FCS is kept on a very tight leash until it is privatized, nothing adverse happens to rural America politically, farmers successfully make the transition to a world without price supports while maintaining conservative leverage ratios, and rural America continues to diversify economically. ***BJ***

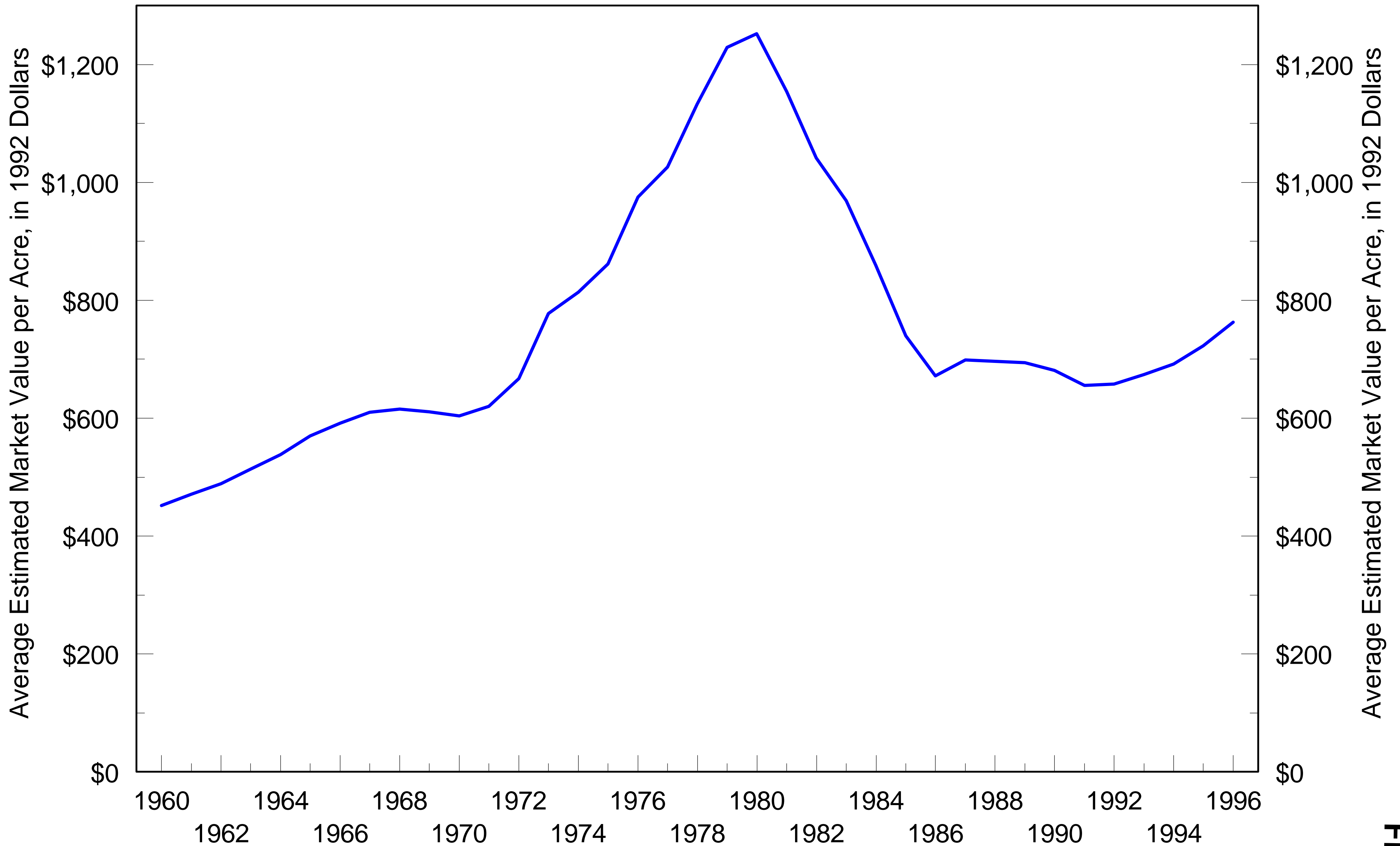


Figure 1

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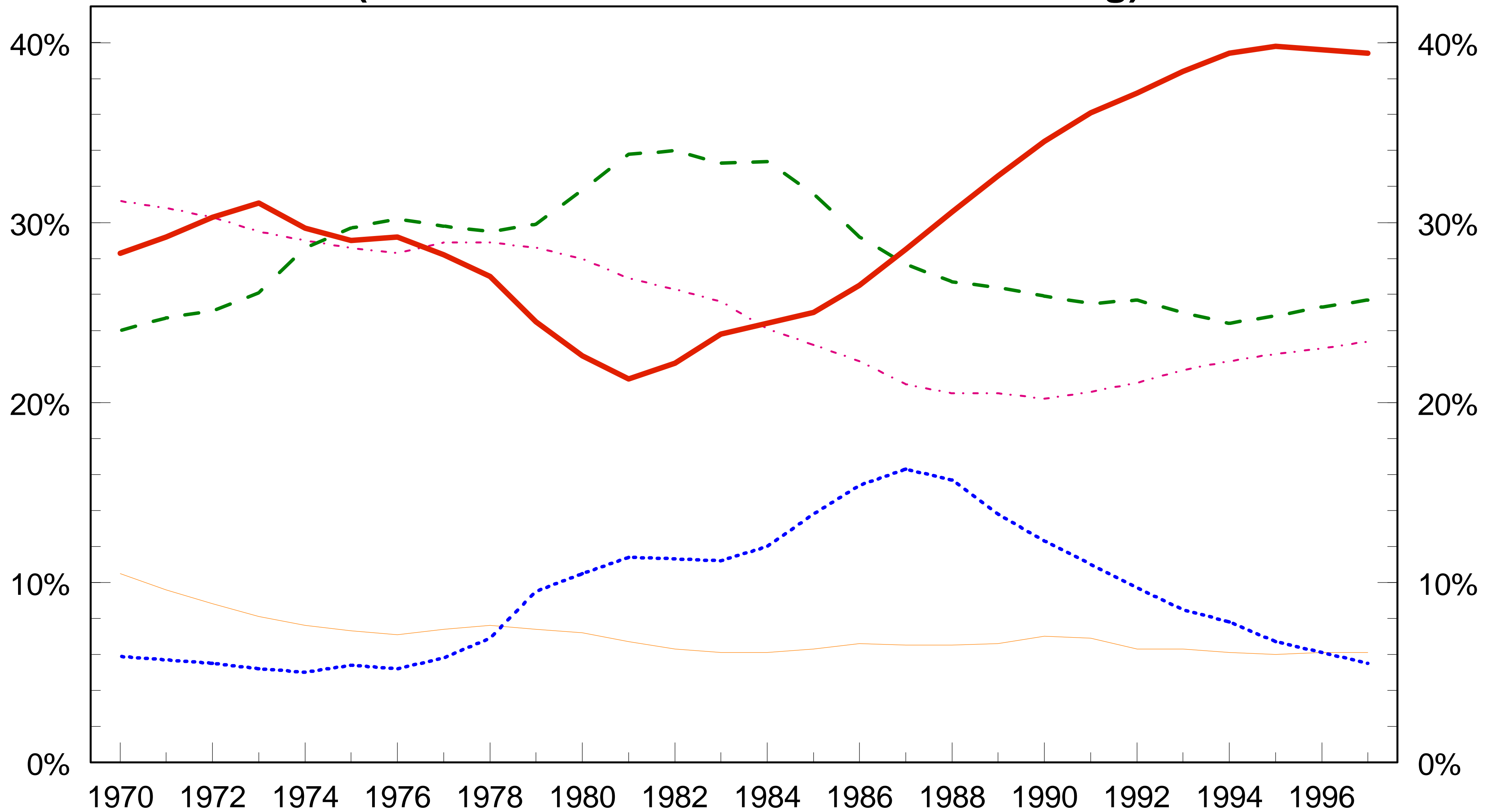
Market Share Trends in Farm Credit

(Real estate and non-real estate lending)



Life Insurance Companies | Farm Service Agency | Individuals and Others | Farm Credit System | Commercial Banks

Note: Estimate for 1997.

Figure 2