THE ECONOMIC REALITIES OF DROUGHT

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Drought! Just mentioning the word is enough to send a chill down the spine of almost any farmer who has previously experienced the problem. The totally helpless feeling that comes with watching crops and pastures withering away in the broiling sun can be devastating. Dreams suddenly vanish, economic hardships descend rapidly, and the long struggle for survival must begin anew.

Drought is not a new problem for agriculture. In fact, history is replete with different episodes on the subject, including the Biblical story in which Joseph offers some timely advice to the Egyptians on grain reserves. Since ancient times, much has been learned about weather patterns and the incidence of drought. Although the question of whether drought is a cyclical event—and hence predictable—or whether it is strictly a random event has not been resolved, it is clear that few regions in the temperate zones of the world are completely immune to the problem.

By definition, drought is a lack of precipitation over a protracted period of time. Therefore, many economic hardships frequently arise in this kind of environment. For individual farmers, the impact of drought is reasonably clear: production will be seriously curtailed and financial losses will likely be heavy. If the farmer is vulnerable to sharp financial setbacks, his ability to repay loans and meet normal living expenses will be jeopardized. Multiplying this situation by the total number of farmers who are similarly affected by drought provides a glimpse into the impact on regional economies. In short, the agribusiness complex begins to shrink because farmers have less to sell. Merchants and dealers will see the demand for their goods and services dwindle, forcing cutbacks in their operations. Moreover, commercial banks and other lenders will likely encounter problems with customer repayment schedules, requests for renewals and extensions, and more delinquencies. In the general economy, consumers may face higher food prices. Clearly, a widespread and prolonged drought can significantly alter the

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course of economic activity and affect overall employment and income levels.

THE CURRENT SITUATION—HOW DRY IS IT?

Since 1973, when net farm income reached an alltime high, drought has been one of the major problems experienced by farmers in a large part of the nation. In general, the area most seriously affected by drought in the past year lies west of the Mississippi River, primarily the Great Plains region from the Texas Panhandle into Canada, and the Pacific Coast region. Weather information from the Department of Commerce shows that during the spring of 1976, precipitation in the eastern part of North and South Dakota, western Minnesota, northeastern Colorado, and central California was at or below 50 per cent of normal. During the summer, this condition spread to the western Corn Belt and most of the central high plains region. The drought condition did not ease appreciably in the fall and less-than-normal amounts of precipitation were received through the winter months over much of this area. Consequently, by spring, soil moisture levels were very low. Furthermore, the reduced mountain snowpack—needed for supplying water to reservoirs and streams for irrigation purposes—is almost certain to lead to water rationing in several places this summer.

The odds are not favorable that adequate precipitation will be received this year to produce normal yields. Within the Tenth District, for example, the chances that the 1977 winter wheat crop will receive precipitation equal to or greater than the amount needed for a normal yield are less than 50-50. And the probabilities for the fall crops, which require a lot of moisture during the hot summer months, are even less favorable than for wheat. This information suggests, therefore, that even if 1977 is a year of normal rainfall, moisture supplies will likely remain deficient in many areas and crop output may fall short of expectations.

The drought situation in California is very serious. Two consecutive years of below-normal precipitation have resulted in water rationing and economic hardships for many Californian. Although ground water supplies are not critically low, the thin snowpack in the mountains and the half-empty reservoirs throughout the state offer little promise that irrigation water will be adequate this summer. A continuation of the drought in 1977 will likely reduce gross farm income in California by at least $1 billion, or about 15 per cent of last year's figure of $8.9 billion. To prepare for this contingency, California's farmers and bankers are working together to develop production plans that will utilize available water supplies most efficiently. Although total output will probably decline this year, it is hoped that net profits from farming in that state will be large enough to avert severe financial distress and a high default rate on agricultural loans.

So, how dry is it? The evidence suggests that many farmers throughout the nation have been adversely affected by drought over the last two years. Although two years is not a particularly long period for drought, the current situation is somewhat reminiscent of the black blizzards of the 1930's and the scorching heat of the 1950's. Another year or two of below-normal precipitation in the grain belts and the far west would likely present the nation with some very serious problems.


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A HISTORY LESSON ON DROUGHT

Before speculating further on what might happen if the drought should continue in 1977, it might be helpful to review earlier droughts. The Tenth District has endured two very severe dry periods during the last half century—most of the decade of the 1930's and the period from 1952 to 1956. Charts 1 and 2 show what happened to wheat production in the District and the rest of the nation during each of these periods. An index is used in the charts for comparing relative changes. Using average production from 1928 to 1932 as the base, wheat output in 1933 and 1934 fell more than 50 per cent in the District, but the relative decline in the remaining 41 states was not nearly as steep. It should be mentioned that while drought obviously contributed to the diminution in output, the economic depression probably had a strong influence on production decisions as well. Indeed, wheat acreage in the District was reduced 10 to 40 per cent during the drought period.

SOURCE: U.S. Department of Agriculture.
In the 1950's the relative decline in wheat output was not as pronounced as it was 20 years earlier. A stronger economy and Government crop programs were probably responsible for holding total acreage in the District reasonably close to predrought levels. However, the drought did have an impact on total wheat production as output was reduced as much as 13 per cent below the average for the 1947-51 period, after taking acreage changes into account. Production in the other 41 states also declined during this period, but this was due almost entirely to acreage reductions as average yields were maintained quite well.

Between 1952 and 1956, feed grain production in the District declined rather steadily, ending up about 20 per cent below the
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1952 figure. For the rest of the nation, output expanded about 15 per cent during this period, which more than maintained total supplies at the national level. Tenth District farmers managed to keep hay output up reasonably well during the drought period by expanding acreage. However, pasture conditions deteriorated sharply, so total roughage supplies were diminished during this period. As a result, livestock producers reduced herd sizes. From the beginning of 1952 to the end of 1956, cattle numbers in District states declined approximately 5 per cent, while hog and sheep numbers were off about 5 and 10 per cent, respectively. At the national level, however, the cattle inventory expanded 5 per cent while hog numbers remained virtually unchanged; sheep numbers fell 5 per cent over the period. Interestingly, consumers may benefit from drought in the short run because meat supplies are temporarily expanded whenever livestock producers reduce breeding stock. Between 1951 and 1956, for example, beef output expanded about 20 per cent, partly reflecting the liquidation of cattle in the drought-stricken regions of the nation.

Because drought hinders productivity, it usually reduces farm incomes sharply in drought-stricken areas. However, for the nation, total farm income may actually increase as curtailed supplies lead to higher commodity prices. In fact, given the nature of demand for agricultural products, a decline in production (supply) is frequently accompanied by a proportionately larger increase in price, resulting in more total revenue than would otherwise be the case. So while drought may cause hardship for the farmers directly affected, it can also provide other producers with some material benefits.

As it turns out, net farm income trended down during most of the 1950's, but these declines reflected buildups in commodity surpluses and falling farm prices rather than drought. However, the reduction in the Tenth District's farm income was certainly compounded by the drought. For example, net income at the national level fell about 25 per cent between 1952 and 1957, but the decline in the Tenth District was almost 50 per cent. Consequently, many producers were placed in financial jeopardy.

The number of business failures and mortgage foreclosures that occurred in the 1950's was relatively small since the drought period was preceded by the longest farm boom in U.S. history, 1940-52. But when income levels finally began to deteriorate, farmers engaged in a belt-tightening exercise. Unprofitable activities were either sharply curtailed or abandoned altogether. Family members looked for outside employment to supplement incomes. Liquid asset holdings were definitely reduced to meet living expenses and repay loans. New investments were postponed, and outstanding loans were renewed and extended (banks were very liquid) as long as there was reasonably good collateral. Good managers utilized moisture conserving techniques in their farming operations. There were some business failures, but these adaptations were enough to prevent the situation from deteriorating into a crisis.

There are a number of lessons to be learned from past drought experiences. One is not to underestimate the productive capacity of American agriculture, even under stress. A drought can cause hardship over a wide area of the country, but total food supplies are seldom reduced significantly because other regions frequently make up the difference. For example, U.S. wheat production was a record 2.14 billion bushels last year, despite less-than-favorable growing conditions in many regions of the wheat belt. In the coming season, a major drought would probably reduce output

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3 For a more complete discussion of the drought experience in the 1950's, see "Impact of Drought on Tenth District Agriculture," Monthly Review, Federal Reserve Bank of Kansas City, May 1957.
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rather sharply, but total supplies for the next marketing year will still be ample because the beginning carryover of wheat is expected to exceed 1 billion bushels. In the case of corn and soybeans, supplies are presently relatively tight. A severe drought in the Corn Belt would cut production and raise prices, perhaps significantly, but output would be unlikely to fall more than 15 per cent below 1976 levels since these crops are also grown in other regions of the country.

A second lesson is that drought rarely leads to sharp rises in retail food prices in the short run. As noted, total grain production usually holds up fairly well during a dry period, while meat supplies may actually expand. If pasture conditions should deteriorate this summer, beef output in 1977 will probably match last year's record level. Nevertheless, the U.S. Department of Agriculture has increased its official forecast range for food prices this year to reflect the weather-related problems of recent months—but only by 1 percentage point. As it now stands, food prices are expected to increase from 4 to 5 per cent in 1977, and a large part of this rise will probably occur on services added after the products leave the farm gate. However, a continuation of bad weather would likely cause food prices to increase somewhat faster this fall and next year.

Still, it needs to be emphasized that prolonged drought does impose severe economic hardships on individual producers and regional economies. The struggle to remain financially solvent can be long and hard, although the American farmer has proved to be remarkably resilient. Certainly, the advent of drought-resistant varieties, improved irrigation systems, and better crop management practices allows farmers to cope with drought much better today than they could have 20 years ago. However, a critical factor in withstanding any adversity is the overall financial health of the industry—as well as that of individual producers.

AGRICULTURE'S FINANCIAL STATUS

The ability of agricultural producers to withstand the financial adversity associated with a major drought can be assessed in a number of ways. If the question relates to the resilience of the industry, aggregate data serve the purpose very well. If, however, the resiliency of individual operators within the industry is being questioned, aggregate data may mask the onset of even quite serious credit problems for individuals or groups of individual producers. Thus, disaggregated measures of financial strength and profitability should also be examined.

An examination of the aggregate farm balance sheet suggests a healthy and profitable industry. By almost every measure farmers are better off today than ten or even five years ago. The value of all farm assets has increased from $281.0 billion in 1968 to an estimated $634.0 billion on January 1, 1977—an increase of 126 per cent. Even when this increase is deflated by the index of prices paid by farmers for family-living items, the gain in constant dollars is about 27 per cent.

During this same period, the realized net farm income increased from $12.2 billion to about $24 billion in 1976, an increase of 97 per cent. The per capita disposable personal income of farmers as a percentage of nonfarm per capita disposable income increased from 70.5 per cent to 89.5 per cent (1975), after having peaked at 109.3 per cent in 1973. In 1956, at the end of the drought years of the early 1950's, farm per capita disposable income was only 47.7 per cent of the nonfarm level. Also, farm families derive a much higher proportion of their disposable personal income from nonfarm sources now than in 1956—50 per cent in 1975 compared to 37 per cent in 1956. This adds a measure of stability to farm income.

Proprietors' equities (net worth) have shown remarkable growth in the past decade,
increasing from $233.6 billion in 1988 to an estimated $534.5 billion on January 1, 1977—an increase of 128 per cent. Proprietors' equities have declined in only one year (1960) since 1956; and since 1971 have increased by yearly increments that are substantially greater than net farm income. This impressive performance has been largely due to the steady increase in farm real estate prices. In just the past five years, average land prices have doubled. In fact, land prices in the Tenth District states of Colorado, Kansas, Nebraska, and Wyoming have more than doubled. Despite some reduction in net farm income from the all-time record in 1973, U.S. farmland prices have continued to increase—12 per cent for 1975 and 17 per cent for 1976 (November 1 to November 1). Tenth District real estate values increased during 1976 by 10.5, 20.0, and 10.4 per cent, respectively, for nonirrigated cropland, irrigated cropland, and ranchland.

Despite the very favorable grain prices of the mid-1970's, and the generally favorable weather across the United States during the 1960's and early 1970's, the substantial gains in farm assets and proprietors' equities depended heavily on the increased use of borrowed capital. Total farm debt on January 1, 1977, amounted to $101.5 billion. Moreover, since 1950, farm debt has approximately doubled each decade. The proportion of total farm debt accounted for by real estate debt has increased slowly for many years to 56 per cent of all debt on January 1, 1977. Concurrently, nonreal estate debt represents a smaller proportion of farm debts, perhaps reflecting some gradual restructuring of the liability side of the balance sheet by farm operators. The increase in the absolute size of farm debt outstanding has not, however, resulted in substantial deterioration of the farming sector's equity position. Proprietors' equities accounted for 84 per cent of the farming sector's assets on January 1, 1977—essentially no different than a decade ago and only 5 per cent less than two decades earlier.

In general, the farm sector has a strong balance sheet and an excellent profit-and-loss statement (especially since 1971). Though use of borrowed capital has increased rapidly, farmers have also enjoyed rapid equity growth. Indeed, agriculture is one of the least leveraged sectors of American business. Aggregate statistics can be deceptive, however. Farm debt is not distributed uniformly over the farm population. Many farm operators are almost debt free or hold a small amount of debt relative to their asset holdings and thus can withstand substantial adversity. Other farmers are highly leveraged and even moderate disruptions in cash flow can place the future of their businesses in jeopardy. Farmers who purchased land years ago have been rewarded with substantial capital appreciation. But those presently purchasing high-priced land find that real estate debt servicing places a heavy burden on the cash flow the land generates. Established farmers generally have built equity they can draw on to meet cash flow demands in periods of adversity. Recent entrants into farming may not have such equity reserve. Some farm operators—such as cattlemen—are already experiencing cash flow disruptions from sources other than drought. Consider the following cases.

The outstanding farm debt is concentrated among larger, more highly leveraged farms. These farm operations are more likely to experience financial distress, as a result of disrupted cash flow, than farms using less borrowed capital. In 1975, farms with gross sales of $100,000 and over—only 3.9 per cent of all farms—held 21.8 per cent of all farm assets and 39.7 per cent of all farm liabilities. Those farms had a debt-to-asset ratio of 28.5 per cent—more than double the ratio for farms with sales between $20,000 and $39,999. These farms generated over 40 per cent of realized gross farm income and over 30 per cent of the realized net income as well. Furthermore, 23 per cent of the capital gains on farm physical

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assets in 1975 have accrued to this same group of farms.

Recent entrants into farming generally have not had time to acquire sufficient equity to cushion the impact of drought-reduced income. Consequently, a substantial proportion of them might be forced out of business as a result of prolonged income reductions. In 1975, almost one-fourth of all Federal Land Bank loans closed were to borrowers under 35 years of age. These young farmers were more highly leveraged than the average Land Bank borrower—they had a debt-to-net worth (leverage) ratio of 69 per cent compared to 53 per cent for all borrowers. Partly offsetting lack of equity reserves, however, 75 per cent of these young farmers received nonfarm income (averaging $23,400).5

Drought may have a more severe impact on certain groups of agricultural producers than on others. For example, cattlemen have generally been experiencing losses for up to three years during the liquidation phase of the present cattle cycle. A recent survey of Tenth District agricultural bankers revealed that 50 per cent of District cattlemen probably suffered decreases in net worth during 1976.6 Furthermore, among those operations experiencing gains in equity, farm real estate value increases were the sole reason in over 80 per cent of the cases. Higher than normal cattle marketings this year—induced by drought—would place a severe financial burden on U.S. cattlemen.

Despite a generally favorable aggregate balance sheet for agriculture, it is clear that some producers are quite vulnerable to serious—and in some cases irreparable—damage to their financial structure as a result of sharp reductions in production or forced livestock sales at unusually depressed market prices. In the Tenth District, for example, over half of the bankers responding to a recent survey said at least half of their farm customers presently have serious cash flow problems and would need renewals, extensions, or restructured loans to solve those problems. Consequently, many bankers are presently reviewing farm loan applications even more carefully than usual—and are frequently requiring additional collateral. There is concern that the quality of many agricultural loans may have deteriorated over the last six months, even though this is not yet clear from available aggregate data.

POLICY ALTERNATIVES

A frequent and almost reflexive response to troubles on the farm is to suggest the problems would largely be resolved if prices were only better—and hence the desire to raise support prices for major affected crops to "fair" levels.7 This approach, though well intentioned, has several flaws. Most obviously, neither higher support prices nor higher market prices provide much benefit to the farmer whose crop has been lost to drought. Higher support prices benefit the large, efficient producers most and likely hasten the demise of small farms, since land resources are bid away from them and they are unable to afford new cost-reducing technology available to the larger operator. To

5 This figure reflects nonfarm income being earned at the time the loan is closed, and is the level of nonfarm income reasonably expected during at least the first year after closing the loan.

8 The Commodity Credit Corporation (CCC) makes loans to farmers, giving them additional flexibility in marketing their crops. The farmers' grain is collateral for the loan. The support price is the value placed on the grain for loan purposes by the CCC. Bushels of grain placed under CCC loan times support price determines the amount of money loaned to a farmer. Since these are nonrecourse loans, the farmer has the option of turning over to CCC—as full settlement of the loan—the grain used as loan collateral.
the extent that support prices exceed market prices, significant long-term economic disruptions can occur. Demand for farm commodities is reduced and, at the same time, excess supplies are accumulated. Artificially high feed grain prices are damaging to the livestock industry at all levels. Hard-won export markets are jeopardized, and production controls usually become necessary to limit accumulation of excess supplies. But perhaps most serious, less-than-optimal resource allocations occur and, as a result, consumers and producers may be less well off than might otherwise be the case. Both in terms of economic impact and timeliness of relief, a much stronger case can be made for specific kinds of aid tailored to needs of distressed operators.

**Assistance to Lenders**

When an area is seriously affected by drought, deposit growth in local banks frequently slows. Decreases in deposit growth more seriously impair local country banks than either large city banks or Farm Credit Banks with access to national money markets. Requests for loan renewals and extensions increase. Local banks may not be able to make all the loans they would like because of limited funds. The nation's 12 Federal Reserve Banks have unique capabilities to augment the banking industry's loanable funds through the availability of a seasonal borrowing privilege for member banks. Those member banks that experience recurring patterns of movement in their loans and deposits may qualify for this seasonal borrowing privilege, whereby loans from the Federal Reserve are made available to them during their entire identifiable season each year. The requirements for eligibility typify conditions encountered by banks serving smaller communities in which the local economy is heavily dependent upon one industry—such as agriculture or tourism. More than 400 banks in the Tenth District are eligible for this seasonal credit service from the Federal Reserve Bank of Kansas City. Furthermore, in the event of severe economic dislocations that may result from regional or local difficulties, such as those associated with protracted drought, Federal Reserve Banks may make loans over more extended periods to affected member banks. With the approval of the Board of Governors, Federal Reserve Banks also may extend credit in such situations to nonmember banks, other corporations, partnerships, or individuals.

**Assistance to Individuals**

Federally guaranteed loans to individual farmers can often serve both the needs of the farmers and those of the local lender. Loans that examiners might classify as substandard—causing a lender to call—may be repaid by a new loan that carries a Government guarantee of total or partial repayment. Thus, the lender can continue to extend funds to the farmer borrower. Such guaranteed loans are made by Farmers Home Administration (FmHA) and the Small Business Administration (SBA). The SBA is primarily involved in lending to small business, though recent authority enables them to engage in certain types of farm lending as well—for purchase of land, equipment, and for operating expenses.

In the event an area is declared a disaster area by the Secretary of Agriculture as a result of natural forces such as drought, flood, or plant disease, etc.—certain emergency programs to provide financial assistance are activated. For example, FmHA makes loans bearing a 5 per cent interest rate available to those farmers living within the disaster area who cannot obtain credit from normal commercial sources. In addition, the SBA can make loans to qualifying farmers to replace physical loss as a result of a designated disaster, such as flood, earthquakes, and tornadoes. Under special circumstances, SBA loans are also available to restore the cash flow of the business. These loans are available up to
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a $500,000 limit if normal credit sources are unavailable.

Emergency livestock loans are presently available (until September 30, 1978) to all established U.S. livestock producers unable to obtain credit through normal commercial credit sources. The Government guarantees 90 per cent of a $350,000 maximum line of credit extended to a borrower by a commercial credit source. Furthermore, the current farm program contains provisions for low-yield payments to producers of all crops with acreage allotments in the event of a natural disaster, disease, or insect damage — providing that these factors are beyond the control of the producer.

A number of other programs can be utilized to provide financial relief to distressed farmers. The Agricultural Stabilization and Conservation Service, for example, offers assistance in defraying the costs of transporting hay to livestock producers in dry areas so that herds can be maintained. The Government, through a cost-sharing arrangement, regularly helps farmers make investments in various soil and water conservation practices throughout the country. And the Federal Crop Insurance Corporation — a Government corporation — offers all-risk crop insurance on 25 different crops in different parts of the United States (essentially in commercial-producing areas for each crop). In this program, the producer can designate the extent to which he wants protection, and the premium is set accordingly. However, Federal crop insurance can be cancelled or denied to individual producers with a high-loss history. Nevertheless, it is very apparent from the above discussion that farmers have access to several programs that help cushion the blow when adversity strikes.

A FINAL NOTE

There is no way of knowing whether the drought problems of the past 2 years will continue in 1977. A surprisingly small amount of moisture, if available at the proper time, will permit crops to grow and reach maturity. However, the fact is that moisture supplies in many regions are low, and the probability of receiving adequate rainfall in the coming months for normal production is not favorable. If the drought should continue in 1977, the Tenth District's farmers and ranchers would likely encounter very serious financial difficulties.

During the 1973-75 period, net income in the District averaged about $9,000 per farm (ranging from $4,600 in Missouri and Oklahoma to $17,000 in Colorado). Furthermore, as of January 1, 1975, the average debt per farm in the District was slightly more than $33,000. This means that for every dollar of net income, the District's farmers and ranchers had approximately $3.65 of debt. Omitting the debt-free operators from the calculations would have increased this figure even more. If, for some reason, serious problems occur and net farm income in 1977 falls sharply, say one-third below the 1973-75 average, or down to about $6,000 per farm, the debt-to-net income ratio in the District would rise to 5.5. While a ratio of 5.5 is not necessarily a danger point, it is clear that in this kind of environment many farmers and ranchers would not be able to repay mortgages and meet normal living expenses without some form of outside assistance.

Fortunately, a wide range of disaster-assistance programs is in place and ready for use when circumstances warrant. And it seems that additional programs are proposed each time a new disaster strikes. *Although more programs

9 The Federal Government has made available, during fiscal 1977, $1.2 billion in drought assistance programs. This will provide funding for grants, loans, and cost-sharing programs. The Administration has called for $844 million in additional aid this year. Most of this aid is available through the Farmers Home Administration, the Small Business Administration, and the Agricultural Stabilization and Conservation Service. However, some of the proposed additional funding for drought relief

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are available for the agricultural producer than for the small businessman serving the producer, the disaster assistance that producers receive, to continue near-normal production practices, partly protects small businessmen in rural communities from disastrous declines in business volume and excessively high levels of delinquent accounts. A present shortcoming in purposes would be available through the Economic Development Administration, the Interior Department, the Bureau of Reclamation, and the Southwestern Power Administration.

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such programs, however, is the time lag from when the need for disaster aid becomes apparent until benefits become available. Unnecessary delays result in needless hardships and anguish to agricultural producers, to small businessmen who service their needs, and to the affected commercial bankers. Therefore, rather than devising new drought-relief programs, policymakers should devote their efforts to adequately funding existing programs as well as to refining and integrating present, disaster programs and procedures so that the assistance machinery runs more efficiently.