Capital for Agriculture and Rural America: Redefining the Federal Role

By Mark Drabenstott

U.S. agriculture depends on capital for its success. Nearly a trillion dollars of capital is at work in production agriculture, with trillions more at work in the rest of the U.S. food system. Public policy has always been concerned with ensuring that farmers have access to adequate amounts of capital at competitive terms. But as is true for many other parts of agricultural policy, substantial changes in the industry now call into question both the degree and type of policy intervention that have been undertaken in the past.

The United States has a highly efficient market for agricultural credit. In many respects, it is a model market for the rest of the world. The agricultural credit market provides ready amounts of credit to farmers, at competitive rates, on terms that suit their unique needs. Without question, public policy has helped to develop this efficient market. But now that it operates smoothly the question is, what should be the public role in the future?

In this testimony, I conclude that while there may be less need today for a federal government role in *agricultural* credit, there may be more need to pay attention to *rural* credit in the future. The rural economy underperformed the metropolitan economy for much of the past decade, and a lack of capital may be one of the causes. In the first section, I show that U.S. agriculture is financially strong and has ready access to capital. Although cutting government payments to farmers poses some risk to farmland values, a critical part of the industry's capital base, other factors could offset smaller government payments. In the second section, I suggest that government intervention in the agricultural credit market is needed less now than in the past. In the third section, I show how the rural economy continues to be sluggish, and why a shift in federal government attention from agricultural credit to rural credit has merit.

AGRICULTURE'S STRONG CAPITAL POSITION

Today's farm balance sheet is healthy, in sharp contrast to a decade ago when the farm recession

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was hitting bottom, or even five years ago when the memories of the farm recession were still fresh. The debt-asset ratio is holding steady at about its long-run norm. Farm asset values are rising slightly in real terms. Farm income has stayed on a solid plateau in recent years—notwithstanding a drop in 1994—providing most farmers with enough cash flow to service their debt. Farm lenders, too, are in strong condition as their portfolios are generally clean and their capital reserves are ample.

Net cash farm income fell 13 percent in 1994, triggering concerns by some that agriculture's financial health was taking a turn for the worse. Agricultural banks in the seven states of the Tenth Federal Reserve District (Colorado, Missouri, Kansas, Nebraska, New Mexico, Oklahoma, and Wyoming) reported slower rates of repayment on farm loans at the end of the year, and that pattern has continued in the first half of 1995. But viewed against the performance of the past several years, and taking into account the special factors in livestock markets that were principally responsible for the decline in income in 1994, agriculture continues to be in sound financial condition. Most producers accumulated cash reserves in the early 1990s on which they could draw for 1994 expenses.

Agriculture's balance sheet provides a good barometer of agriculture's continued financial strength. Farm assets grew more than farm debt in 1994, lifting farm equity for the third straight year. Agriculture's debt-asset ratio remains at 16 percent, very close to its long-run average and well below the 23 percent that signaled the onset of the farm debt crisis of the mid-1980s.

As farmers have gathered financial strength, so too have their lenders. The capital ratio of the nation's agricultural banks has risen steadily since the mid-1980s and now stands at 11 percent—higher than the capital ratio for nonagricultural banks. The Farm Credit System (FCS) has built up its capital base from less than $4 billion in 1988 to more than $10 billion today. Farm lenders thus have considerable capital to cushion any financial shocks that might arise.

Against this general backdrop of financial strength, agriculture has begun to increase its debt. Farm debt increased 2 percent in 1993 and 4 percent in 1994 after four years of holding steady. Recent evidence from agricultural banks suggests some of the increase is due to weaker incomes and a rolling over of some agricultural loans. Nevertheless, banks remain generally positive about the overall health of farm borrowers.

With farm debt climbing again, questions have begun to arise about whether the supply of credit to agriculture is adequate. In part, the questions stem from rising loan-deposit ratios at commercial banks that lend to agriculture, which have captured most of the recent loan growth. In the Tenth Federal Reserve District, for example, loan-deposit ratios at agricultural banks now top 60 percent for the first time in a decade. Even though agricultural banks are more fully loaned up, there are no widespread indications that credit is unavailable to creditworthy borrowers. To the contrary, relatively few banks report a shortage of loanable funds. What is more, competition for qualifying farm loans remains keen among agricultural lenders.

Looking ahead, there are risks to agriculture's current financial health. Farm income is expected to be steady in 1995, and recent market trends support that outlook. But unexpected changes in production and prices could lead to another drop in farm income in 1995, which might deepen financial concerns for producers that had lower income last year.

Potential cuts in farm programs and the impact of such cuts on farmland values pose another risk to the outlook. Farmland accounts for three-fourths of total farm assets, so changes in its value have a fundamental bearing on agriculture's overall capital base. As a significant part of farm income for many crop producers, government farm payments have boosted farmland values. Accordingly, reductions in farm payments will lead to a downward adjustment in land values.

The amount and timing of such an adjustment will be determined by many factors. The effect of cuts in farm programs on farmland values, therefore, must be viewed in a broad context. A critical determinant of land values will be the future course of commodity prices. If the current outlook for sustained growth in agricultural exports is realized, commodity markets could restore much of the loss in government payments. Another powerful determinant of farmland values will be long-term market interest rates. As Chairman Alan Greenspan has noted in Congressional testimony, moving toward a balanced budget would lead financial markets to lower long-term interest rates. Thus, if cuts in farm programs were part of a broad, credible effort to reduce the federal budget deficit, the resulting decline in long-term interest rates would help mitigate, at least in part, the decline in farmland values. Taken together, this broad mix of farmland determinants suggests that steep, general declines in land values such as seen in the mid-1980s are unlikely.

Overall, agriculture is in strong financial condition. Even though farm income fell in 1994, agriculture's balance sheet remains fundamentally strong. Potential cuts in farm programs would have a downward effect on land values, but the impact will depend importantly on forces at work in commodity and financial markets.

THE FEDERAL ROLE IN AGRICULTURAL CREDIT

The agricultural credit market has not always been as efficient as it is today. When the twentieth century began, farmers faced credit shortages, uncompetitive interest rates, and poor terms. Public policy played a vital role in correcting many credit market ills. Federal intervention has taken two broad forms: a closer of market gaps and a lender of last resort. Comparing these roles with agriculture's current and prospective credit needs suggests a more limited federal role in the future.

A closer of market gaps

An efficient credit market has two central features: competition and access to broader capital markets. When one or both are lacking, borrowers suffer from uncompetitive interest rates, insufficient credit, or both. History shows that the most successful federal credit programs, whether aimed at agriculture or other sectors of the economy, have focused on enhancing market efficiency while avoiding credit subsidies (Bosworth and others).

The federal government has played a central role in chartering new financial institutions for agriculture that encourage competition or enhance farmers' access to capital markets. On these two counts, perhaps the most successful chartered institution is the Farm Credit System (FCS). Created in 1916, the FCS has grown to become one of agriculture's main sources of credit, giving farmers a direct channel to the nation's capital markets. More recently, the federal government chartered Farmer Mac to encourage more competition in farm mortgage lending and to provide lenders a means of tapping markets for securitized loans. Although slow to develop, Farmer Mac remains very much in the long-standing spirit of closing market gaps.

Few gaps are left to be filled in the agricultural credit market. Put another way, the market is highly efficient. Interest rates to farm borrowers are linked to market interest rates. Lenders compete keenly over quality farm loans. Commercial banks, the FCS, and life insurance companies all actively seek farm loan customers, and new lenders have entered the market. A growing portion of farm debt is provided by farm input companies, such as makers of farm equipment or farm chemicals. And, as more and more farm production falls under production contracts (a trend known as industrialization) agricultural processors are becoming a more prominent source of credit (Drabenstott).

Some may argue that federal programs are needed to ensure agriculture's access to capital markets, particularly as loan-deposit ratios rise at agricultural banks. But the FCS retains direct access to capital markets, and more of the loans to agriculture made by commercial banks are at larger banks with better access to funds. To the extent that small agricultural banks suffer a shortage of loanable funds, the problem might be addressed through existing market channels, such as viable secondary markets or perhaps giving community banks access to FCS funds.

A lender of last resort

Another role of the federal government in the agricultural credit market is to be a lender of last resort. Most agree this is a legitimate role for the federal government to play. What is unclear is how broad the mission should be. A review of past experience and the structure of the industry provides three conclusions that point toward a more limited role of government lending.

First, subsidized credit programs to agriculture have been difficult to contain and have diffused the mission of the federal government as a lender to agriculture. The Farmers Home Administration, predecessor to today's Consolidated Farm Service Agency (CFSA), began with a limited mandate in 1946: to provide subsidized farm ownership loans. In the postwar period, FmHA's mandate was successively broadened to include everything from rural housing and water systems to economic emergencies. Thus, the FmHA was administering many loan programs when the 1980s farm recession hit and it was simultaneously called upon to be a lender of last resort to agriculture in the truest sense.

Second, the costs of being a lender of last resort are high when lending guidelines are defined only in broad terms. There was widespread agreement that the FmHA should provide assistance to debt-strapped farmers in the mid-1980s. There was not agreement, however, on the length of assistance. In the end, the FmHA provided long-term assistance to many farmers at a steep cost to taxpayers. During the past ten years, the FmHA has written off nearly $16 billion in farm loans.

An alternative approach would have been to stress temporary government assistance of perhaps a few years in length. Although difficult to estimate precisely, such an approach almost certainly would have cost taxpayers less, and may have left many of the farmers that ultimately quit farming with more equity. Against the backdrop of the past decade, guidelines that stress temporary assistance aimed at graduating farmers to commercial lenders appear to be more appropriate, especially in light of Congressional efforts to balance the budget.

Third, the new structure of production agriculture seems likely to reduce the need for government lending in the future. Commercial farms with annual sales greater than $250,000 are only 6 percent of all farms, yet they account for more than half of farm sales and have an average net worth greater than $1.5 million. It is difficult to argue that such farms need government loans. While small farms represent the vast majority of the nation's farms, they increasingly turn to off-farm income for most of their family income. Over the long run, these farms will be helped more by economic growth in rural America and less by subsidized farm credit programs.

In sum, past experience and the industry's changing structure both point to a reduced role for direct government lending to agriculture in the future.

FROM AGRICULTURAL CREDIT TO RURAL CREDIT

For several decades, the federal government's involvement in rural credit markets has focused almost entirely on agriculture. The logic was that if agriculture's capital needs were met, the farm economy—and thus the rural economy—would fare well. That logic no longer works. The rural economy is much too diverse for agriculture alone to sustain it. In fact, fewer than one in four rural counties depends primarily on agriculture. Thus, a strong farm economy is no longer sufficient for a strong rural economy.

Even in rural areas where farming predominates, greater economic diversity is needed to ensure economic viability. The farm economy has enjoyed a sustained recovery since the mid-1980s, but the upturn has not been sufficient to promote general economic growth in most farm-dependent counties. From 1988 to 1993, for instance, job growth in farming counties was slower than in metropolitan counties or most other rural counties.

The rural economy has been generally sluggish for more than a decade. Growth in employment, one broad gauge of economic activity, averaged 1.2 percent a year from 1980 to 1993, the last year for which county-level data are available. That compares with job growth of 1.7 percent a year for the nation as a whole and 1.8 percent a year in metropolitan areas. Since 1990, jobs have grown faster in rural than in metropolitan areas. The more favorable comparison is the result of some pick-up in rural growth coupled with a sharp decline in metropolitan growth due to the 1990-91 recession. In 1993, the gap between rural and metropolitan areas narrowed substantially. The rural job gains have been concentrated in roughly half of the nation's rural counties.

There are three reasons to believe that a lack of capital may be a factor contributing to the sluggish growth in the rural economy. First, rural nonfarm businesses tend to depend heavily on community banks as their lender, and these banks draw most of their deposits from local funds. Thus, the credit market for many rural borrowers may have limited competition and limited access to capital markets. Farmers, by contrast, can select from a number of lenders, and some of these have direct access to capital markets.

Second, rural development experts generally agree that rural entrepreneurs face greater difficulty assembling start-up capital than their urban counterparts. Community banks and their regulators have good reason to limit a bank's risk exposure to start-up companies. Moreover, commercial banks can provide equity capital only by forming business development corporations.

Finally, loans are growing more slowly at rural commercial banks than at metropolitan banks. Over the past 15 years, loans have grown 5.6 percent a year at rural banks, nearly 1.25 percentage points less than at metropolitan banks. The slower growth probably reflects weaker demand for loans, although it could also suggest reluctant lending practices by some rural bankers. Regardless of the cause, the slower rate of loan growth underscores a slower rate of capital formation in rural areas.

In short, the rural capital market may be less efficient than the agricultural credit market. The number of rural credit suppliers is fewer, and community banks, the leading lender to rural businesses, have less access to broader capital markets than agricultural lenders like the FCS. While the spread of interstate banking across the nation will give rural borrowers greater access to capital markets, many rural businesses will continue to rely on community banks as their main source of credit.

Is there a federal role in making rural credit markets more efficient? Let me be clear in stating that the rural credit market does *not* need an infusion of subsidized government credit. What the market does need are initiatives that will enhance competition and enlarge its access to broader capital markets—the same sort of initiatives that have made the agricultural credit market so efficient. In the main, rural initiatives can build on existing market institutions and could be implemented at minimal cost to taxpayers.

Four federal initiatives might be considered. First, the federal government might commission a comprehensive study of rural credit markets. Such a study is lacking and would help to guide any new federal initiatives. Second, new programs might be considered to assist entrepreneurs starting rural businesses. Sluggish rural economic growth may be caused by a lack of *human* capital as much as *financial* capital. Several development specialists conclude that many rural businesses lack the management or technical expertise to be successful. Moreover, most community banks are small and lack the staff or experience to evaluate rural business start-ups, especially if they are in emerging industries that are new to the community.

Third, because community banks are so important to rural capital formation, new initiatives that enhance their access to capital markets should be explored. Steps worth considering include enhancing secondary markets and providing new means of tapping capital markets, such as new partnerships with the FCS.

Finally, new ways to improve rural venture capital markets should be considered. Equity capital may be a greater constraint to rural businesses than debt capital. It is unreasonable to expect community banks to solve this problem; they are in the business of providing loans, not equity. Because venture capital markets are poorly developed in most rural areas, public/private partnerships that pool the risks of placing equity investments may be a way to promote capital formation with limited public funds. Some states have initiated venture capital funds that offer promise for the future (Markley and Shaffer).

In sum, after decades of federal intervention in the agricultural credit market, the focus of public attention may shift to rural credit in the years ahead. The performance of the rural economy continues to trail that of the metropolitan economy. Addressing that gap begins by recognizing that the rural economy is much more diverse than agriculture alone. Finally, a handful of federal initiatives could strengthen rural credit markets by enhancing the availability of equity capital and providing community banks better access to capital markets.

CONCLUSIONS

Capital is vital to the farm and rural economies. Agriculture and its lenders today are financially strong, and capital is readily available to creditworthy borrowers. The nation's agricultural credit market is highly efficient, thanks in part to past federal initiatives, such as the chartering of the FCS and Farmer Mac. Few gaps, if any, remain in this market, suggesting more limited federal involvement in the future. With a diverse rural economy trailing the metropolitan economy, public attention to the rural capital market would produce more economic benefit than continued focus on agricultural credit alone. New rural federal initiatives should be aimed at increasing competition in the rural credit market and expanding access to broader capital markets.

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