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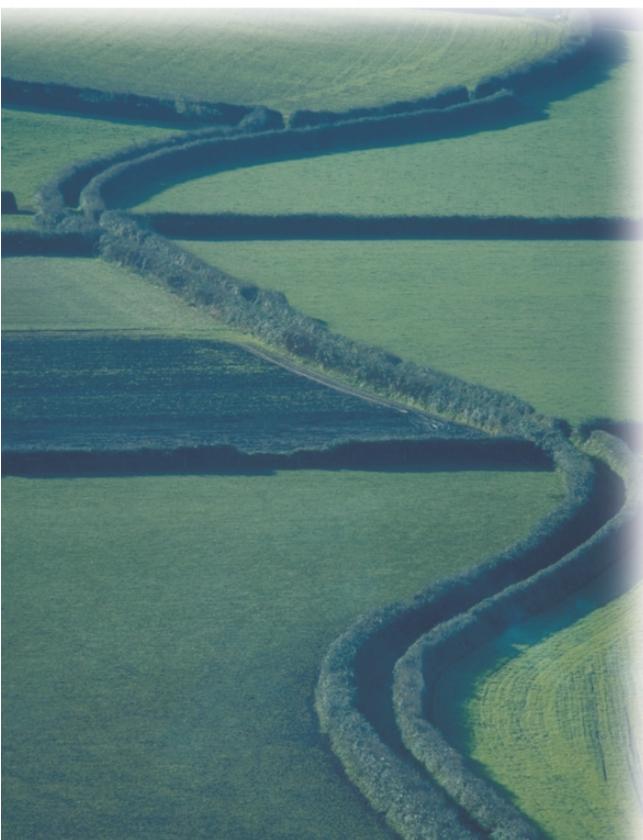
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# *The* Main Street \_\_\_\_\_ Economist *Commentary on the rural economy*



## Sizing Up the Farm Downturn

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**T**he U.S. farm economy has fallen on hard times, conjuring up memories of the farm financial crisis of the early 1980s. Agriculture's financial circumstances today, however, differ markedly. Unlike the 1980s, the industry entered the current downturn with a rock-solid balance sheet, strengthened by steady gains in farmland values and modest debt levels.

Still, with market prices for most farm commodities mired in a deep slump, some erosion in agriculture's financial foundation is under way. How deep that erosion runs will depend on how quickly foreign demand for the industry's bounty recovers and how willing Congress is to shore up the industry until then.

**Rising production hits shrinking demand**

The hallmark of agriculture's current slump is weak prices for the nation's leading farm commodities. Farm prices hit the skids when a surge in production collided with a drop in demand, especially in key foreign markets. Production of the nation's leading crops—corn, wheat, and soybeans—ratcheted up in recent years, driven by good weather. At the same time, beef, pork, and poultry production climbed to record or near record levels.

The bigger production, however, met an ill-timed slump in agricultural exports, which account for nearly a fifth of the industry's total sales and even more of Midwest field crops.

Beginning in the summer of 1997, the wave of financial turbulence in key Asian and Latin American markets shrunk incomes and weakened currencies, trimming demand for U.S. farm products. As a result, U.S. farm exports in fiscal 1999 are expected to dip to \$49 billion, the third yearly drop in a row and down about 18 percent from the 1996 record.

With production up and exports down, U.S. crop inventories swelled. At the current rate of usage, crop inventories would last about 2 1/2 months for corn and soybeans and 4 1/2 months for wheat. These inventories are less than half as big as the burdensome stockpiles that accumulated during the farm bust of the 1980s. The key difference is that much of the crop inventory in the 1980s was isolated from

the market in various government warehouses and reserve programs.

Almost all of today's crop inventories remain available for immediate sale into the market, weighing heavily on market prices. During the last two years, prices have fallen about 25 percent for corn and wheat and 35 percent for soybeans, dropping well below most estimates of production costs. This year's harvest is shaping up as another big one, promising to keep bins full and prices low for months to come.

Government price supports also appear to have helped run up production and depress prices, especially for soybeans.

farmers to shift acreage from other crops to soybeans.

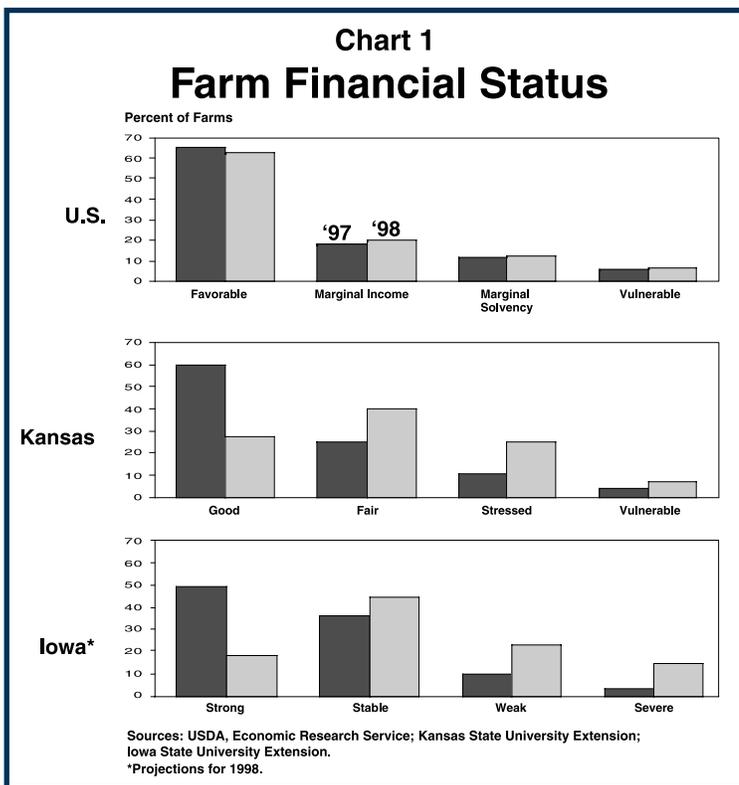
There is an advantage of lower grain prices: lower feed costs for livestock producers. The lower feed costs and stronger cattle prices have enabled cattle feeders to earn solid profits in recent months after incurring deep losses last year. The nation's cattle ranchers also appear to be starting a cyclical expansion in their breeding herds. As they retain breeding stock that would otherwise be sent to slaughter, beef production temporarily slows. Thus, cattle prices are expected to remain strong in the months ahead, further brightening the industry's profit outlook.

Lower feed costs have also helped hog producers, although the industry's big expansion in recent years has continued to hold hog prices at barely breakeven levels for many farmers. Nevertheless, breakeven or slightly better is a big improvement from last winter, when the industry's expansion outran slaughter capacity and hog prices plunged to their lowest level in nearly 30 years, triggering huge losses for pork producers.

Last year's big losses and prospects for little or no profit this year have hastened the pork industry's structural shakeout. Many small producers are exiting the industry and many others are joining a rapid shift to "supply chains"—tightly orchestrated production, processing, and marketing arrangements stretching from genetics to grocery. By joining supply chains, producers exchange some production flexibility for margins that are fixed contractually, reducing their exposure to big swings in hog prices.

**Farm finances erode**

The tumble in farm commodity prices has begun to erode farm finances. Three recent studies suggest, though, that the level of financial stress emerging across the nation varies widely. The three studies—one for the nation, one for Kansas, and one for Iowa—classify individual farms into four groups of financial health (Chart 1). The definitions of financial health differ



Under current farm programs, farmers can collect a subsidy that makes up the difference between a government support price—called the loan rate—and a lower market price. Thus, the loan rate sets a floor beneath the price farmers expect to receive for their crop. The wheat and corn loan rates appear to be set low enough that farmers are not encouraged to expand production. But the soybean loan rate of \$5.26 a bushel has been above market prices since early this year, encouraging

somewhat among the three studies, but the studies' results are strikingly similar.

All three studies reveal a general downshift in farm financial health from yearend 1997 to yearend 1998. The national study suggests the downshift was relatively modest among all farms in the nation, with the proportion of farms in the weakest condition staying almost steady at about 6 percent. The downshift was considerably more striking in the Kansas and Iowa studies, where grain and livestock are the farm mainstays. The proportion of farms in the weakest shape nearly doubled in Kansas to about 7 percent and increased about four-fold in Iowa to about 14 percent.

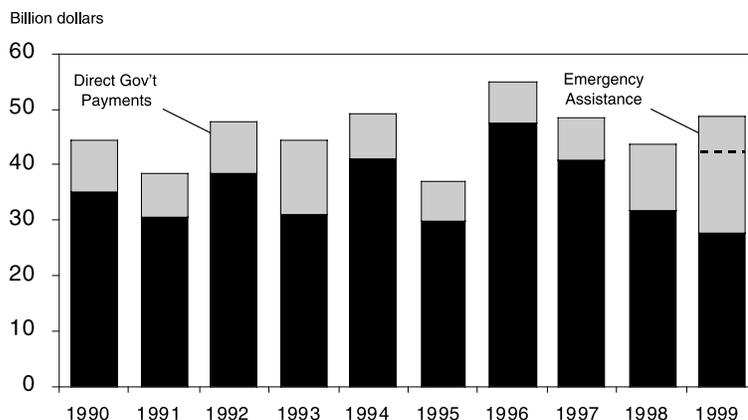
These data provide convincing evidence of a downshift in farm financial health during 1998. It remains to be seen what shifts have occurred this year or what shifts might still lie ahead. Still, this year's weak crop and hog prices suggest financial erosion will continue for many farms.

### Government help boosts farm income

The financial pressures many farms face this year will be mitigated by the most generous government assistance on record. The nation's net farm income in 1999 could total \$49 billion, well above the average for 1990 to 1998 (\$45.5 billion) and only a few billion below the 1996 high-water mark (Chart 2). This year's farm income estimate includes an expected \$21 billion in direct government aid, exceeding the record \$16.7 billion subsidy distributed to farmers in 1987. About \$5.5 billion of this year's government payments were included in a broader package of emergency aid for farmers totaling \$8.7 billion and approved by Congress in mid-October.

Washington's generosity promises to relieve some of the sting of weak markets, despite a determined farm policy shift in 1996 designed to end agriculture's reliance on government support. Congress' debate of this year's financial aid package for farmers touched on the always nettlesome issues of how much aid is appropriate and how it should be distributed. Thus, the farm

Chart 2  
U.S. Net Farm Income



Source: USDA, Economic Research Service.

downturn has tested the nation's new market-oriented farm policy and set in motion a debate on the direction of farm policy after current farm legislation expires in 2002.

### A solid balance sheet provides breathing room

In addition to the government help, a solid balance sheet will also help the industry ride out the downturn. A key factor in strengthening the farm balance sheet in recent years has been gains in farmland values. After tumbling in the early 1980s, average farmland values in the nation hit bottom in 1987 and then began climbing (Chart 3). Trends in farmland values are in themselves a key bellwether of agriculture's financial health, since farmland is about four-fifths of the industry's asset base.

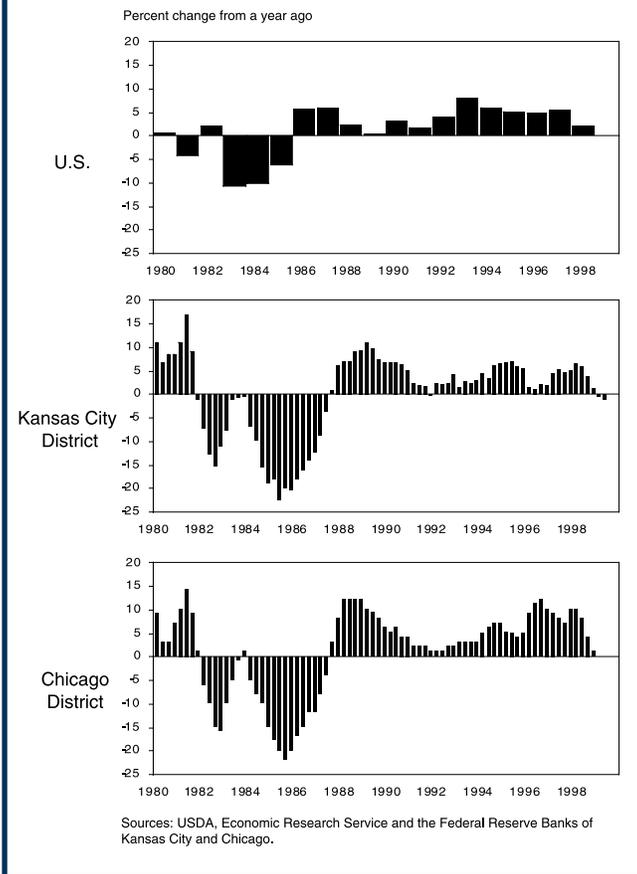
With farm income prospects down, however, farmland values are beginning to soften. Average farmland values in the nation rose just 2.2 percent in 1998, the smallest gain since 1992. More recent data for the first half of 1999 suggest land values have slipped in some regions. In the Kansas City Federal Reserve Bank's seven-state region (Colorado, Kansas, Missouri, Nebraska, New Mexico, Oklahoma, and Wyoming), average land values edged down about 1 percent during the year ending June 30. During the same period, land values

also softened in the Chicago Federal Reserve District, especially in Illinois (down 7 percent), Indiana (down 4 percent), and Iowa (down 3 percent)—states dominated by corn, soybean, and hog production. The slippage in farmland values is sobering, given the importance of farmland on the farm balance sheet. Still, the recent declines are small compared with both the drop in values during the early 1980s and the run up since.

In addition to gains in farmland values, cautious borrowing has helped keep the farm balance sheet strong. Farm debt has increased in recent years, but at about \$171 billion the industry's debt burden remains well below the \$193 billion peak recorded in 1984. The cautious borrowing has held down agriculture's overall debt-asset ratio, which shows how much of the industry's asset base was purchased with borrowed money. At 16.5 percent, this key indicator of overall financial strength has edged up only slightly in recent years and remains well below the early 1980s crest of 23 percent.

The cautious borrowing is also reflected in the generally good shape of farm loan portfolios. At commercial banks, for example, the share of farm real estate loans that were noncurrent (at least 90 days past due) on June 30 remained almost unchanged

**Chart 3  
Farmland Values**



from the year before at 1.5 percent. Noncurrent farm operating loans edged up slightly during the year to 1.7 percent, still a relatively modest level compared to the mid-1980s crest of more than 8 percent.

More farm loans are likely to sour in the months ahead if farm commodity prices and incomes stay down. But farm lenders appear relatively well positioned to handle additional problem farm loans if they arise. Lenders have used strong profits in recent years to build up their capital-to-asset ratios, which measure the lenders' financial reserves available to cushion against future loan problems. At midyear 1999, the average capital-to-asset ratio was a solid 11 percent among commercial banks that specialize in lending to farmers and more than 15 percent in the Farm Credit System, agriculture's big cooperative lender. Thus, a considerable financial reserve stands between rural communities

and another wave of farm bank failures like that of the mid-1980s.

**Conclusions**

The nation's farm economy is in a deep slump, triggered by sharply falling exports just as the industry ramped up production. Weak grain and livestock prices have caused some erosion in farm finances, especially in the Midwest and Great Plains. To date, however, the farm downturn pales in comparison to the farm financial bust of the 1980s. How deep the slump will go and how long it will last depend on how soon farm exports recover. In the meantime, generous government assistance and the industry's solid balance sheet promise many farmers some breathing room.

Key Asian markets are beginning to bounce back, signaling a rebound in farm exports. Farm exports, however, are notoriously volatile. With grain inventories relatively lean, grain prices could remain weak or spike up, depending on how fast foreign markets rebound. Nevertheless, another big harvest this year promises to keep grain bins full and crop prices down for some months to come. While cattle producers are earning solid profits again, the profit outlook for hog producers remains bleak. Thus, some further financial erosion is likely to appear when lenders review their farm loan portfolios this winter.

Looking farther ahead, the 1990s farm financial downturn underscores the importance of the global marketplace to U.S. agriculture. Policies that promote an open and growing world market enhance incomes in the developing world, boosting demand for U.S. agriculture's bounty. Thus, the industry has much at stake in

the next round of world trade negotiations, which kick off late this year with a meeting of the World Trade Organization in Seattle. A successful outcome in these negotiations is U.S. agriculture's best long-term bet to bolster its future. With that thought in mind, the Seattle WTO negotiations will be the focus of the December issue of the *Main Street Economist*.

*Nancy Novack, research associate, helped prepare this article.*

The Center for the Study of Rural America will track the shifting currents in the rural economy each month in *The Main Street Economist*. In-depth studies of major rural economic and policy issues will appear in the Federal Reserve Bank of Kansas City's *Economic Review* and other publications. Next spring, we will launch a new national conference on rural issues.

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