THE CHANGING CREDIT PICTURE IN AGRICULTURE

Remarks by Chas. N. Shepardson, Member, Board of Governors, Federal Reserve System, at Fourth National Agricultural Credit Conference, American Bankers Association, at Morrison Hotel, Chicago, Illinois, on December 2, 1955.

Agriculture has truly become a major industry as well as a "way of life" -- an industry fraught with all of the problems of adequate investment and operating capital, production efficiency, markets, and salesmanship that confront any other industry, in addition to the hazards of nature with which the farmer has always had to contend.

For years we have thought of industry and of agriculture as if they were separate and distinct economies, each with its own peculiar characteristics. Too frequently we have not fully appreciated that the developing trends of recent years have led to a situation in which the similarities between the farmer and the city producer are fully as striking as the differences.

Farm output for human consumption has advanced throughout our history but the advance has been greatly accelerated during the past 15 years. Prior to 1900, this increased production was largely the result of expanding land frontiers and increased acreage in cultivation. From 1900 to 1940 science and technology played an increasing role as land frontiers diminished. During the past 15 years, with a fairly stable acreage in cultivation, output has increased 35 per cent even with a decrease of 28 per cent in farm population. This latter increase is almost solely due to increased productivity per acre and per man-hour and has been brought about by the astounding advances in agricultural science and technology and the substitution of capital for labor. There was a time when a man with a team, a wagon, a plow, and a cow, a sack of seed and enough determination could move onto a government homestead and, by long hours of hard work and sacrifice, build himself a farm and a home. That condition no longer exists. Today the farmer must have technical "know-how" as well as integrity and he must have access to adequate capital as well as willingness to work. The increased productivity to which I have referred has made not only possible but necessary the enlargement of the family farm unit if the operator is to make the most efficient use of modern technology and machinery. As a result, the capital requirements have become staggering in terms of our former standards for farm credit.

The value of production resources on typical commercial family-operated farms outside of the South, in 1954, ranged from an average of $25,000 for dairy farms to an average of over $100,000 for some grain producing farms. The average investment on Southern family farms was much smaller, ranging from $10,000 to $20,000. While the large number of these small farms reduced the national average, it still amounted to about $23,000 per farm in 1954, or nearly four times the 1940 average of $6000, and it is continuing to increase.

These figures refer to the physical capital used in farming -- the land, buildings, livestock and equipment. They do not take account of the value of a modern dwelling and modern household equipment, which are almost an essential part of the farm equipment if we expect to hold our capable, ambitious young farmers and their families on the farm. Neither does it include the operating capital necessary to meet current cash expenses, which are also increasing from year to year. These two items may well add another

$8000 to $10,000 to the average. Usually this large capital investment on a farm must be obtained and controlled by one individual.

The whole technological revolution in agriculture of the last 15 years is reflected in these figures, as well as the effect of the much higher price structure of the economy. With the increases that have occurred, the capital needed per worker in the agriculture industry now exceeds the capital required in manufacturing and other off-farm activity.

In looking at a breakdown of these figures, one finds further reflection of the drastic change in farm production methods and operations in the dollar investment in machinery and equipment. Before the war, the average farm in this country -- including both small and large farms -- had an investment in these assets of about $400. Today the machinery inventory averages $3,100, about eight times the 1940 level. On a typical commercial farm, outside the South, the necessary machinery and equipment may be valued at $10,000 or more. Even in terms of constant dollar values, the current investment in machinery and equipment is nearly four times that of 1940.

As you know, the cash operating expenses have increased greatly since before the war, reflecting, in part, this increase in investment needs and, in part, the increased quantity and variety of other items that farmers must purchase to produce at lowest possible cost.

Production expenses per farm in 1954 averaged about four times the 1940 level, or $4,300 compared with $1,050. Expenses have remained at high levels in these recent years of declining farm prices and have now started to rise again as many of the items purchased by farmers begin to reflect the price increases occurring in the prosperous nonfarm economy. Production expenses, as compared with prewar, are relatively higher than gross farm income. In fact, farmers' net return per dollar of gross receipts this year will be smaller than for any other year of record except in the depths of the depression in 1932. Farmers' net income will be about 32 per cent of their gross compared with 46 per cent in 1947-49, and 36 per cent in 1940. This smaller share of gross emphasizes not only the cost-price squeeze of recent years but also high cost structure facing farmers and the shift that has occurred from home produced to purchased power and supplies. With increased overhead in terms of capital investment and increased operating costs, the need for increased efficiency and increased output per operating unit is obvious. In this connection, it is interesting to note that the biggest increase in operating expense is in the cost of depreciation on machinery and equipment, further emphasizing the importance of volume per unit.

What are the implications to lenders of the great changes in farm capital needs and in production expenditures? The situation can be summarized as follows:

(1) The much larger and more complex enterprises that farmers manage now require a range of skills and knowledge so broad that the average farmer frequently finds himself in need of expert assistance. This is especially true in his borrowing and investing decisions.

(2) To a much greater extent than in the past, credit, properly used, must be one of the tools by which farmers acquire and operate today's efficient enterprises. We should expect that average debts per borrower will be much larger than we have been accustomed to think of in the past, particularly among beginning farmers or for farmers on units being converted to new types of farm operations.

(3) An increasing share of farmers' credit needs are for intermediate term types of investment. I feel this is one of the most important areas of farm lending today.

We have noted the relatively rapid rate of farm mechanization. Farm machinery is a semi-permanent type of investment which produces income over a number of years. Just as the income is received over a period of years, similarly a loan to purchase such machinery should properly be repaid over a period of years. Machinery is only one of several important investment needs that are neither fixed capital, as land, nor current operating capital, such as crop expense. With the high cost of land, farmers are turning more and more to making their present land holdings more productive. Many soil conservation measures and irrigation systems also require and merit longer term credit than is usually available.

A similar situation is found in the case of the farmer who needs to change his farming operation to a new type better suited to market conditions, to the resources of the farm, or to his particular interests and aptitudes. Such cases are common in areas of the West and South, particularly where the loss in export markets has had the most severe effects, but are found to some extent in all areas. Here there is a need for a form of intermediate credit which permits matching the loan advances to the steps in the conversion process and the terms of repayment to the expected flow of income.

The need for intermediate credit to farmers is not entirely new. It was an issue throughout the 1920's and some new farm credit institutions were set up at that time. The need always becomes greater at times of declining prices and rising costs when farmers find themselves unable to finance such expenditures from one year's net earnings. It is especially pressing at present because of the rapid growth in intermediate term items needed on farms. Some day our loan statistics will have a three-way break to include intermediate term loans, in addition to the present two-way break on mortgage loans and short-term loans. However, before we reach the state when such lending is as commonplace in agriculture as it is in industry, we must learn a great deal more than we now know about the methods best adapted to such lending. Techniques which will permit this type of lending need to be developed.

In making intermediate term loans, it is imperative that a realistic and careful appraisal be made of the situation, including not only the integrity, industriousness and collateral of the borrower but also his capability and the soundness of his plan of operations, at least for the period of the contemplated loan.

As mentioned before, modern farming is a highly complicated undertaking, involving a wide variety of technical and business problems. Unless the borrower has the training or is willing to seek and use the advice of competent specialists, he is not apt to be a good risk regardless of his collateral for no business transaction is a desirable one unless it promises to be mutually profitable to both parties.

In appraising the borrower's proposed plan, there are several points to be considered. First, is the unit large enough or can it be made large enough without prohibitive cost to provide an adequate living for the operator and his family and still leave enough margin to repay the loan over a reasonable number of years? Second, is the land adapted or adaptable to the contemplated use? Much of our present farm problem comes from the misuse of land. In spite of years of concentrated emphasis on soil conservation and proper land use, we still have vast acreages with a low or hazardous crop potential that should be returned to grass or timber.

Is the borrower's schedule of anticipated income realistic in making due allowance for weather cycles and market fluctuations? The present difficulty of many wheat farmers and cattlemen is in no small measure due to the unwarranted optimism generated by the unusually good weather and abnormally high prices during the war and early post-war period. A sound plan for term credit should make provision for years of uncontrollable adversity but it should also require off-setting prepayments in years of higher than anticipated returns. It should also take account of the possible effects of quotas and acreage allotments and have sufficient flexibility of alternative enterprises to meet such conditions.

The farm plan should be a living document, laying out the broad outlines of the farm operation for the period ahead. It must not be regarded by the borrower as a useless paper which he signs to get the loan and then promptly forgets. A properly prepared plan is a joint product in which the borrower and lender are both vitally interested and which will, in fact, be referred to frequently. It should be subject to appraisal periodically, based on actual achievements, and should be flexible enough to be modified by mutual agreement if conditions require such change.

Banks with agricultural representatives are ideally suited to making such loans and they appear to be increasingly interested in this development. Other banks which are not staffed with agricultural specialists may find it somewhat more difficult. Banks with agricultural people and those without them should avail themselves of the assistance of county agents, SCS personnel and other Federal and State agricultural people in developing such plans.

City banks can be of much assistance to their correspondent banks in helping them to develop this phase of their farm lending service. In addition to the technical assistance which the city banks can provide, they may at times be asked to participate in the larger loans for which the local banks' resources are not adequate. A sound farm plan and loan agreement make a highly desirable, if not absolutely essential, basis for appraising such participations.

It is of doubtful value to the individual or the community to assist him in continuing on an inadequate unit which shows little promise of being substantially improved and where the applicant runs the risk of seeing his lifetime savings and possibly the land itself gradually dissipated. Those borrowers who cannot develop an economically profitable unit, either because of lack of physical and financial resources or because of insufficient managerial capacity, should be encouraged to supplement their farm earnings with part-time, off-farm jobs or, in some cases, even to consider full-time, off-farm employment. This latter move often results in the individual improving his own position and at the same time allows the land to be recombined into larger and more efficient units. With the present cost price situation in agriculture, everything possible should be done to promote greater efficiency.

In this connection, we should not overlook the credit needs of the part-time farm operators. If a person has a reasonably secure, off-farm job or can get one and operates his farm on a part-time basis, his loan repayment ability can be based on these earnings as well as on the earnings from his farm. Thus, it may be possible to help him on a sound basis whereas his farm earnings alone would not justify the loan.

The management potential of the prospective borrower -- a major consideration in today's complex farm operations -- can be appraised to some extent on the basis of his past performance. Some appraisal can also be arrived at, based on the knowledge and judgment that he exhibits in mapping his farm plan. Addition of or conversion to a new enterprise always entails some risk and such moves should be undertaken gradually and with sufficient flexibility so that the plan can be slowed down or speeded up as developments warrant.

At first this farm planning may seem onerous and costly. However, the experience gained in processing earlier plans will serve as a basis for the more expeditious handling of subsequent cases. Many of the problems encountered in preparing one plan will be common to others. As stated earlier, Federal and State agricultural workers can be of help. They can help formulate the basic data needed, such as land use classification, crop yields, price prospects, crop and livestock production goals, and similar considerations. They may be able in some cases to work with a prospective borrower in preparing a specific plan for his farm, to be submitted with the loan application.

The service that a banker can render to agriculture in financial planning has been mentioned. Since a prospective borrower must scrutinize his projected income and expense picture carefully when a farm plan is prepared, he is less likely to purchase a machine or some other item that he does not actually need for greater efficiency. Bankers can perform an important service to farmers by helping them to limit their expenditures to those items which are most likely to improve their efficiency and income.

It should not be implied from these remarks that banks are not meeting these credit needs, particularly in the intermediate term area. Some banks have been doing an excellent job in this field for several years. Others, which are equally interested in serving their farm customers, have felt they were restrained from making such loans due to some regulatory restriction. In this connection, the Federal Reserve Board has recently stated in a letter to all Federal Reserve examiners that there is no Federal law or regulation which prevents commercial banks from making intermediate term loans for agricultural purposes and that such loans, made on a sound credit basis, are not to be considered as undesirable.

Some bankers have attempted to meet this situation with annual renewals of short-term loans. It is entirely possible that such loans may have been criticized by examiners if the terms of the note were not being met even though the lender and the borrower both understood that renewals might be necessary over a period of years before the loan could be liquidated. It is also possible that some bankers may not have realized the needs or potential opportunity for profitable service in this field.

Lenders, of course, need protection so if a lending operation is not going properly or there is danger of loss the operation can be straightened out or the loss minimized as quickly as possible. This protection can be afforded with a properly prepared farm plan and with a loan agreement that embodies the necessary safeguards. It is much better that these safeguards be written down specifically and accepted by both parties so the borrower, as well as the lender, knows exactly what is expected. The borrower is thus assured that the financing will be available in the amounts and on the terms promised if he meets the terms of the agreement.

We have little knowledge of the over-all extent of intermediate term lending to farmers and we need to know more. The Federal Reserve System is considering the desirability of a study of agricultural lending by commercial banks in the not too distant future. It is hoped we will learn from the study the extent of bank participation in intermediate term lending and some of the characteristics and conditions of such lending.

So far, I have dealt mainly with one phase of the agricultural credit problem. There are a few general observations I would like to make. From 1940 to 1945 the ratio of total farm debt to total assets dropped from 1:5.3 to 1:10. From 1945 to January 1, 1955 that ratio has narrowed slightly to 1:9. To the extent that rising debt reflects added investment in productive resources, it may be indicative of increasing productive efficiency. To the extent that it represents operating losses, it is a matter of grave concern. Unfortunately, available data do not show which of these two predominate. We do know, however, that agricultural credit is in a relatively strong position. Mortgage debt at present represents only 9 per cent of the market value of farm real estate compared with 20 per cent in 1940 and even higher in earlier years. While the total farm debt represents 11 per cent of total assets, reflecting, at least in part, the increasing amount of machinery, equipment and livestock purchased on credit, it is still low compared with 19 per cent in 1940. It is indeed fortunate that this healthy debt situation exists at this time of falling prices. While the legitimate needs for agricultural credit must be met, it is important that it be done with discernment to the end that this healthy situation may be maintained.

Compared with the rest of the economy, total farm debt increased approximately $10 billion in the last 10 years against an increase of $200 billion in non-farm private debt. This indicates the tremendous demand for available credit. Some fear has been expressed that because of this condition agriculture would be adversely affected by any measure of credit restraint. While tightening credit may increase the credit cost for farmers, it is relatively to their advantage. The rest of the economy is booming. Demand is crowding capacity in many areas and this pressure is beginning to be reflected in price increases. The farmer is already suffering from the cost-price squeeze. With little immediate prospect for any material improvement in farm prices, any further increase in the cost of things the farmer has to buy would only accentuate that squeeze. This is further emphasized when we realize that the cost of outstanding farm credit represents less than 5 per cent of total farm costs.

In closing, then, we may say that agriculture is still in a strong credit position and worthy of the credit needed for furthering productive efficiency and that any credit restraint which will minimize the upward pressure on non-farm prices and hence on the cost of farm production is to the advantage of agriculture even though it results in some slight increase in the cost of farm credit.

There is a real challenge to country bankers these days to continue to lead in financial service to the farm community. There is a pressing need to improve efficiency on many farms, to adapt the agricultural production plant to the changing demands of our domestic and export markets, and to help farmers learn better management techniques. Your attendance at this conference is evidence of your interest in these problems. I am sure you have the imagination and initiative to continue your leadership in this important field.

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