INTERMEDIATE TERM CREDIT - THE NEED AND THE CHALLENGE

Remarks by Chas. N. Shepardson, Member, Board of Governors, Federal Reserve System, at the Eighth Annual Colorado Farm and Ranch Credit Conference, The Shirley-Savoy Hotel, at Denver, Colorado, on March 29, 1956.

This country has just finished one of the most prosperous years in its history. Gross national product, industrial production and personal income were all at record levels while consumer prices generally maintained an even keel. In spite of drought and flood in some areas, production of crops and livestock was also at record levels. With bounteous production and a high level of consumer purchasing power, this should have been a top year for agriculture. Instead, we saw agricultural commodity prices continue to decline while non-farm commodity prices rose at an offsetting rate. The drop in farm prices more than offset the bounteous production with the result that farm income continued to decline in contrast to a material increase in non-farm income.

Naturally, this has given rise to widespread discussion about the farm problem and the all too-frequent assumption that government can and should have the answer to solve it. Certainly, government has a part to play. Many of the conditions that plague us now are the result of government actions in the past. Some of them were necessary in the public interest, especially the production incentives during the war. Some, however well intended, were of doubtful wisdom from their beginning. Some of those which were justified under war conditions may be of doubtful wisdom now. They constitute government problems and sooner or later they will be solved by government.

But there are many things that agriculture can and must do for itself and many things in which commercial banking has both the opportunity and responsibility to play a part. Your presence at a conference of this kind is evidence of your awareness of this fact and your interest in it. I want to congratulate the Colorado Bankers Association on sponsoring such a program and my alma mater, the Colorado A. and M. College, on cooperating in it. I also want to express my appreciation of the opportunity to participate in these discussions with you.

First, let us review briefly the present situation of agriculture. Land prices advanced throughout 1955 in most sections of the country and now stand at or slightly above their peak level of 1952. Farm mortgage debt increased during 1955 but the increase was more than offset by rising land values so that real estate debt amounts to slightly less than 9 per cent of market value compared with 20 per cent in 1940 and even higher levels in earlier years. While non-real estate debt also rose during 1955, total farm debt still represents only about 11 per cent of total assets compared with 19 per cent in 1940.

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 the total of farmers' equities continued to rise, amounting to three and one-half times as much in 1955 as in 1940, and that agricultural credit is still in a relatively strong position in most sections of the country.

Increased productivity per acre and per man-hour by means of advances in agricultural science and technology has resulted, in the past fifteen years, in a 35 per cent increase in output despite a 28 per cent decrease in farm population. This high and increasing level of productive efficiency, the strong equity position of farm operators, and the continuing high level of consumer purchasing power are all indicators of strength in the agricultural picture. Offsetting factors include the burdensome and mounting surpluses of many farm commodities, unsound land use, losses of foreign markets, falling prices, and rising costs, all of which have resulted in a reduced net income from farming.

These latter problems are receiving the attention of the Congress at the present time and I would not venture to guess what the outcome will be. In the meantime, let us consider some of the credit problems growing out of the changes of the last few years.

The high level of our national economy at the present time is largely due to our increasing productivity, resulting from the substitution of capital in the form of equipment, facilities and technical "know-how" for physical labor. This is true in agriculture as well as in other segments of the economy. 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 farm 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, in 1955, ranged from an average of $25,000 for dairy farms to an average of over $100,000 for some grain producing farms. Including the large number of small farms in the South, the national average amounted to about $24,000 per farm in 1955, compared with an average of $6,000 in 1946. 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 farm equipment if we expect to hold our capable, ambitious young farmers and their families on the farm. Neither do they 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 $8,000 to $10,000. 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 fifteen years, as well as the rise in price structure of the economy, is reflected in these figures. With the increases that have occurred, the amount of capital needed per worker in agriculture now exceeds the amount required in manufacturing and other off-farm activity.

Before the war, the average farm in this country had an investment in machinery and equipment of about $400. Today the machinery inventory averages $3,100, and 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 per farm in machinery and equipment is nearly four times that of 1940.

Production expenses per farm in 1955 also averaged about four times the 1940 level, or $4,500 compared with $1,050. 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. These changes symbolize the change in farming from a largely self-contained, manual operation to a highly complicated commercial business.

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.

This increased borrowing involves three types of credit, namely - (1) long-term mortgage credit, primarily for the acquisition of land, (2) intermediate-term credit for the acquisition of equipment, facilities, breeding livestock and major land improvements or shifts of enterprises from which the returns accrue over a period of years, and (3) short-term production credit.

With rising land costs and the need for larger holdings to provide an efficient operating unit, the problem of land acquisition is becoming increasingly difficult, especially for the beginning farmer. There would seem to be real need for more accurate appraisal of land values based on long-range productive capacity. Some farmers are in difficulty today because of marginal land bought at inflated values based on a few abnormally good years. On the other hand, loan values on good land are frequently held unrealistically low. Loan limits might also be raised on amortized loans which provide for variable amortization payments based on earning capacity of the operation.

Short-term production credit has normally been adequate and, while the need for operating capital is constantly increasing, the good operator can usually secure his needs, although not always at as favorable terms as might be desired.

The relatively new and increasingly important need is for more intermediate term credit. This 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 the present time.

We have noted the 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 striving more than ever to make 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. 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.

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. The strong probability that the added investment will produce a more profitable return on the entire operation should be a key factor in granting the desired extension of intermediate term credit.

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 offsetting prepayments in years of higher than anticipated returns. It should also take account of the possible effect 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. 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.

Banks with competent agricultural representatives should be in excellent position to make 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.

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 have an increasing opportunity and responsibility 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 he operates his farm on a part-time basis, his loan repayment ability may well be based on his job 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. 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.

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. In fact, there is reason to believe that some farmers and ranchers over-invested in stock or equipment during good years beyond the capacity or need of their operation over a long-time average. 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 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.

We have little knowledge of the over-all extent of intermediate term lending to farmers and we need to know more. Some day our loan statistics may 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. The Federal Reserve System is planning a study of agricultural lending by commercial banks in the near 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.

Heretofore, farm financing has been a rather scattered and haphazard undertaking, distributed among private mortgage holders, merchants, nonbanking institutions, and commercial banks with little consideration to the over-all needs or capabilities of the entire operation. The farm plan and loan agreement suggested above would seem to provide an excellent vehicle for a package program to cover the entire farming operation. There is an increasing and justifiable need for long-time and even continuing use of borrowed capital. The farm plan and an open-end mortgage might be the basis for a continuing "open line of credit," which would do much to put commercial farming on a par with commercial business so far as financing is concerned.

I would like to add one other point. We are in a period of delicate balance so far as the stability of the economy is concerned. Consumer disposable income is at a record level. Consumer demands, together with investment expenditures by businesses, by State and local governments, and by home builders, are pressing on productive capacity in many areas with corresponding upward pressures on prices of industrial materials and products. This is a matter of concern to all of us and, more particularly so, to the farmer who is caught between rising costs and a level of prices for his produce which has little immediate prospect of improvement as long as the market is under the present burden of agricultural surpluses.

While everyone might like a little inflation in his own business, I think all of us realize the long-run importance of maintaining the value of the dollar. This is becoming of increasing importance with our increased reliance on insurance, pension plans and similar fixed income devices. In the face of excessive demand on existing production and inflationary price pressures in the industrial area, we must find a way to curb these pressures without unduly restricting the flow of credit into the creation of added production facilities.

This calls for real discretion and unselfish statesmanship on the part of lenders to see that available credit, which is adequate for a continued high level of economic activity and growth, is allocated to the best long-run good of the community. This means a prudent restraint on extensions of credit for speculative or consumption purposes -- even though more remunerative -- to the end that adequate credit may be available for the expansion or improvement of the more essential production facilities. It is especially important, in an agricultural area such as this, that lenders adjust their allocations of credit in such a way as to assure the availability of credit to meet the legitimate needs of farmers. Only in this way can we hope to come out with a strong, vigorous farm economy when the present imbalance of farm production to demand is corrected.

In closing, let me say that agriculture is still in a strong credit position. While we have some serious problems of rising surpluses and falling prices, aggravated in some areas by drought, there is reason to hope that some remedial legislation may be developed in the foreseeable future. In the meantime, I am sure that commercial bankers will continue to strive to meet the legitimate and meritorious credit needs of good farmers and that you will assist and encourage them to develop better management techniques, improve their efficiency and adapt their production unit to the changing demands of our domestic and export markets.

- - -