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Agricultural Credit: Turmoil and Possible Alternatives

by

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Declining red meat consumption per capita, a strong dollar in the international money markets, high interest rates and erratic farm programs have placed South Dakota farmers and ranchers under considerable financial stress. However, beyond the stress for agricultural producers, these have also been trying times for agricultural lenders and the financial community. Deregulation of the financial sector has resulted in traditional participants being assaulted by a broad range of new competitors. Brokerage firms, money market funds and major retailers such as Sears are just a few examples of the "new" firms competing for the savings of the average American. In addition, agricultural lenders, agribusinesses and producers have been forced to shift from a collateral based lending boom to lending practices stressing the producer's ability to repay loans from current cash flows.

In this newsletter, the implications to agricultural producers and lenders of the recent changes in agriculture's management philosophy are examined. These implications are then related to possible pricing and product alternatives in the agricultural financial market.

The Change in Agriculture's Management Philosophy

The "old" management philosophy was based on the perception that the agricultural producer was a successful commodity speculator. Protection of profit margins or commodity inventory values took backseat to speculation on commodity prices and land values. Commodity prices had to go up eventually. Why miss the chance of participating in the next big price movement like during the early 1970's? Land values had only one direction to go, upward. Fortunes were to be made through speculation rather than from the net earnings from farming and ranching. Unfortunately this "old" management philosophy proved to be inadequate for the realities of the agricultural economy in the 1980's.

The "new" 1980's management philosophy recognizes that even though the producer may be a commodity marketer, s/he still has to be a margin maker. The producer will place increased management emphasis on establishing a margin between costs of production and revenues rather than speculating on increases in commodity prices and land values. The "new" philosophy may not appear to be so "new" to those who farmed and ranched prior to 1972, a period when agricultural lenders were more conservative in their lending practices.

Not Just a Return to the "Good Old Days"

But do not fall into the trap of believing that we are simply returning to the "good old days." The rate of technological change is accelerating in American business and agriculture. Agriculture is more dependent on pur-

chased inputs and export markets. Instability in the prices of commodities and inputs is a stark reality. Producers and agribusinesses have increased in size and specialization. Prior to 1971, a producer could ignore forward contracting, futures markets, computers, interest rates and farm record systems. The "new" environment will not permit this type of management philosophy to survive. Risk management and risk management tools are moving to the center stage of the "new" management philosophy.

The "new" management philosophy will stress the establishment of profit margins for producers through the forward pricing of inputs and outputs. Speculation of price improvements on commodity inventories will be part of a planned market strategy rather than the result of "gut" feelings. Producers will seek to lock in favorable input prices to control production costs. The central focus of the management philosophy will be anticipation.

Anticipation and Futurist Agriculture

John Naisbitt in Megatrends has argued that change is occurring so rapidly there is no longer time for successful businesses to simply react to change in their environment. The change must be anticipated. Producers and agribusinesses must realize that a fundamental change has occurred in what determines who will succeed in agriculture. In traditional agriculture, we looked to grandpa to train us on how to produce by the tried and true method. In modern agriculture, we have turned to current technology to determine who will succeed. In futurist agriculture, the successful agriculturalists will be those that properly anticipate technological innovation and position themselves for the innovation. Agricultural finance is entering into this futurist agriculture.

Agricultural lenders, agribusinesses, universities and producers must strive to create the institutional

mechanisms that will enable this "new" management philosophy to exist. Agricultural lenders must consider product innovation for agriculture. Recognition must be given to the fact that money and capital have increasingly taken on the characteristics of a commodity.

Money and Capital as a Commodity

Since 1979, major changes have occurred in the pricing of capital and in competition for capital. In October of 1979, the Federal Reserve began stressing the achievement of its goals through the control of the money supply rather than the control of the federal funds rates. Interest rates were allowed to fluctuate with changing demand and supply conditions in the credit markets. In addition, the commodity called "money" has become an international commodity in its price and locational movements. The combined impact of these changes has been increased instability and uncertainty about the level and direction of interest rates. To deal with the instability and uncertainty, a major new market has developed to transfer this risk. This market is the financial futures market and could be a source of change in the way agricultural lenders do business.

Growth and Volume of Financial Futures Markets

Many agribusinesses and producers are familiar with the traditional futures contracts for grains, oilseeds and livestock. But everyone in agriculture must realize that the real revolution and growth area for the futures markets since 1976 has been the financial futures. In 1983, the soybean futures contracts were the second most actively traded futures contract with 13.7 million contracts being traded at the Chicago Board of Trade. In 1983, 16.7 million Treasury bond contracts were traded. The cash value of the trading in financial futures equaled more than \$2.0 trillion dollars in 1983.

Just as agribusinesses and pro-

ducers use the commodity futures market to hedge, an increasing number of financial institutions and non-financial corporations are using financial futures to hedge against interest rate changes. Money has become a commodity with a constantly changing price (interest rate). Just as agribusinesses and producers can experience major financial losses from lower prices for their grain and livestock inventories, financial institutions can experience major financial losses if the price changes occur for financial instruments in their inventory. Therefore, financial institutions also have incentive to hedge in the futures market and use other risk management techniques.

A basic question is whether it is feasible for agricultural lenders to adopt some of the risk method transfer and pricing mechanisms existing in the grain trade. Can agricultural lenders develop new management tools for producers to control the interest rate risk?

Possible Alternatives

Could forward pricing contracts in agricultural credit like we have in grain marketing be developed? For example, assume that in the fall a grain producer believes interest rates will be two or three percentage points higher when he needs his spring operating loan. He goes to his local financial institution and signs a forward contract for a specific interest rate. He would not borrow the money from the bank until the funds were required for spring planting. Hedging in the financial futures markets would enable the financial institution, in turn, to protect itself against an adverse interest rate movement. Since interest rate futures contracts exist for as many as two years into the future, this may provide the ability for financial institutions to offer more flexible loan agreements.

The grain merchandising sector has a tradition of bidding the price of their grain commodities with reference

to a specific futures contract. For example, corn may be priced at "20 cents under the May contract." If the May futures contract is trading at \$3.25, the cash price is \$3.33 or \$3.53 minus 20 cents. Does the potential exist for pricing credit in a similar manner?

The pricing of credit on the basis of the futures market would facilitate the hedging by borrowers and the financial community. For example, a borrower could establish an interest rate two percent over a September Treasury bill futures contract. The loan's interest rate would be tied to a specific futures contract. This would insure that the agribusiness could effectively hedge its variable interest loan. An increase in the loan interest rate would be exactly offset by a change in the interest in the futures contract.

Problem Areas in the Use of Financial Futures

Current financial futures pose certain problems for agriculture. A major disadvantage is the large size of financial futures contracts. For example, the Treasury bill futures contract on the International Monetary Market has a contract size of \$1.0 million, while the Mid American Commodity Exchange's Treasury bill futures contract has a contract size of \$500 thousand. To use the financial futures, an agribusiness must be large or must participate in some form of pooling arrangement. Also, the large size of the futures contracts points toward the fact that the lender will be the one doing the hedging in the futures market rather than the borrower.

Another disadvantage is the lack of financial futures contracts that directly relate to the needs of agriculture. For example, there does not exist a futures contract by which a producer or a cooperative can hedge the variable interest rates of the Farm Credit System. In the same manner, producers and agribusinesses can not find a futures contract that enables them to hedge the prime rate or the variable



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interest rates of other private sector lenders.

Also, a question arises of whether financial futures are a cheaper method of transferring interest rate risks than traditional financial risk management strategies of the lenders. Such an analysis is beyond this brief article, but serious effort should be directed toward improving the producer's ability to control his interest expense. The financial community may want to examine more closely the risk transfer mechanisms used in other industries, where price risk is a very important dimension in the management of business.

Conclusion

Access and cost of capital will continue to be a primary concern for South Dakota agriculture. Agricultural lenders must realize that competitive niches will not go unexploited in the deregulated economy. The financial relationships in agriculture and agribusiness will be increasingly regulated by economics rather than regulation or tradition. Increasing pressures will develop to link the pricing of credit in South Dakota agriculture to national and international money markets.