Anatomy of an American Agricultural Credit Crisis
Farm Debt in the 1980s

Kenneth L. Peoples
David Freshwater
Gregory D. Hanson
Paul T. Prentice
Eric P. Thor

with an Introduction by
Emanuel Melichar

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Introduction

Ten years ago, the unthinkable began to happen to the farm sector and its financial institutions. The outlook for commodity prices and farm income worsened abruptly as an export boom collapsed with little warning.

Most farmers, and especially most producers of major crops, had just experienced their most prosperous decade ever, and were looking forward to more of the same. Many had recently made capital investments—purchased land, upgraded machinery, installed irrigation or silage systems, put in grapes or other permanent plantings. Some had incurred relatively heavy debt when making these investments—a strategy that for years had enabled good farm managers to achieve more rapid growth in their income and wealth.

Now the world of this heavily indebted group crashed with astonishing speed. Not only did their income falter—especially in comparison with the gains they had counted on—but interest rates on their debt had risen to nightmarish levels. And in short order the value of their farmland—which, in an analytical sense, had been based on expected higher income discounted at lower interest rates—began a rapid descent.

As the loans of heavily indebted farmers increasingly became delinquent, financial trouble spread to financial intermediaries with significant involvement in farm lending: commercial banks, some of the larger life insurance companies, and the Farm Credit System (FCS). In an assortment of ways, these institutions raise funds from the general public—promising timely payment of interest and repayment of principal—and use these funds to make farm loans and other

loans and investments. If more than a very small percentage of their borrowers become unable to service and repay their loans, the intermediaries are in trouble.

Thus the greater the importance of farm lending to the intermediary, the more trouble spelled by rising farm loan defaults. The life insurance companies were thus least affected. Many rural banks also benefited from the diversification of their loans and investments. Of about five thousand agricultural banks existing in 1981, there were 328 that failed over the next ten years; however, for the group as a whole the average return on equity never fell below 5 percent in any year, and the ratio of capital to assets—already high compared with that of other banks—actually improved during the decade.

And so, the most specialized farm lender—the Farm Credit System—was the most severely impacted, with problems that threatened to undermine its effectiveness for many years to come. Interestingly, just as agricultural banks as a group had established a strong capital position during the preceding years of farm prosperity, so had the Farm Credit System as a whole. And just as agricultural banks as a group did not come close to failing, neither did the FCS if viewed as a single entity: total capital was about $8 billion at the time of its final "rescue" in 1987—far above estimated prospective losses of about $3 billion. But agricultural banks were not a single entity, and several hundred did fail; nor was the FCS effectively a single entity, and by the mid-1980s a number of its parts were insolvent or nearly so. To avoid years of chaos in farm financial markets, federal assistance was advisable and was indeed provided, with the Farm Credit System Assistance Board created to play a key role in that operation.

It turned out that the downward spiral of the farm credit crisis had reached bottom in 1986, as judged from farm loan delinquency rates and farmland prices. A remarkable recovery ensued, based in large part on huge government income payments to farmers and further aided by the restoration of order to the operations and viability of the Farm Credit System.

Thus, over the past twenty years the farm sector and its financial institutions have experienced, first, ten years of euphoric boom, then five years of traumatic bust and, so far, five years of quite significant recovery.

The account, analysis, and interpretation of the tumultuous years of boom and bust, and of the federal government's response to the credit crisis of the mid-1980s, is vividly presented in this monograph, as one would expect from authors who, in their various capacities as

analysts or administrators, were immersed in the unfolding events and engaged in studying, devising, or administering governmental policies and actions. At the U.S. Department of Agriculture, Paul Prentice had primary responsibility for reporting the surprising macroeconomic events that were shaping the farm boom and bust, and for analyzing and forecasting their impact on the farm sector. Also at the Department of Agriculture, Greg Hanson in the mid-1980s conducted and published numerous analyses of farm income and finance and of the incidence and impact of financial stress on individual farms. After also working on farm finance at the Department of Agriculture, Dave Freshwater became the farm credit specialist of the Senate Committee on Agriculture, and he provides a fascinating insider's account of the development of the legislation that restructured and assisted the Farm Credit System. From the vantage point of associate administrator of the Farmers Home Administration (FmHA) in 1986—and as the very first president of the Farm Credit System Assistance Board—Eric Thor describes certain legislative and other initiatives of the FmHA during the worst years of the cycle. Finally, as the first general counsel and now president of the Farm Credit System Assistance Board created to carry out some of the most sensitive and vital aspects of that legislation, Ken Peoples provides an authoritative account of how the FCS Assistance Board went about its task and achieved generally satisfactory outcomes.

Persons who lived through and were involved in the farm boom and bust may feel inclined to skip the initial "what happened and why" part of this monograph because that material is part of their own personal knowledge and experience. I urge otherwise. Nowadays, many persons—be they farmers, lenders, or economists—are offering explanations of these events that feature various aspects of stupidity and greed as causal factors. But such conclusions have little value. For example, some persons cite lending procedures and investment decisions that "obviously" should have been done differently. They thus apparently fail to appreciate that those different ways would have been inefficient, illogical, or even untenable in the earlier circumstances, or that—even if they *were* then a viable option—they could have led to different but equally serious future problems. A thoughtful perusal of the historical record will yield fresh insights into how difficult it is, especially during unusual times, for farmers and lenders to evaluate risks and choose the actions that will prove best in hindsight.

A career in economics and finance is likely, as the foregoing indicates, to make one simultaneously appreciative of and cautious

toward the "lessons" of history and previous experience. One must study the past but still realize that at any point later in real time one may, perhaps, know what has really happened so far, but is much less likely to know what is really happening right then, and is definitely in the dark about what will happen next.

In 1955 when I was a student and still knew everything, I wrote the following prediction during Dr. Norton's class in agricultural finance: "We are near the expected peak of the farm real estate cycle and future prospects of a level of income to support land prices at this peak are not very good." Twenty-five years later, I was pointing out that real income from farmland had risen at an average annual rate of at least 4 percent during the intervening period! I also then reported—at the Agricultural Outlook Conference in 1980—that, based on asset pricing theory, the price of farmland in 1980 implied expectations of continued earnings growth at about the same rate. Calculations using the five-year forecasts of farm commodity prices published at that time in *Business Week* and *Farm Journal* would easily result in such earnings growth to 1985. Farmland was appropriately priced in the light of such forecasts.

I had also just published, in the *American Journal of Agricultural Economics,* a table showing that, if expectations of annual growth in real earnings of farmland were to fall from 4 percent to zero (flat earnings), farmland prices would theoretically fall by 52 percent. This soon became reality, and farmers and lenders who had made the most enlightened calculations and forecasts went bankrupt. Under similar circumstances, it has to happen again. Anything else would be irrational!

Emanuel Melichar
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