TRADE, THE BUDGET, AND POLICY: WHAT DO THEY MEAN FOR FARMERS AND LENDERS?

Neilson C. Conklin
Vice President and Chief Economist
The Farm Credit Council

As we approach the 21st century American farmers and ranchers face three major realities:

-- Real farm income remains flat and real income for the farm sector as a whole is not expected to rise in the next decade.

-- American agriculture is highly dependent on export markets. Half our wheat, one-third of our cotton and nearly one-fourth of corn currently go to foreign markets.

-- Government support for farmers and federal intervention in agricultural markets are declining. The decline in direct payments is highly visible but the diminishing use of other policy instruments -- such as supply controls, price supports and government stocks -- are also important.

What do these realities mean for American farmers and ranchers? And what do they mean for financing American agriculture in the 21st century? These are the questions I would like to explore in my remarks today. But first lets take a look at the trends behind these three realities.

REAL NET FARM INCOME IS FLAT

Nominal farm income has risen by almost 30 percent during the last decade. But *real* farm income declined by 3 percent during the same period, as inflation eroded the gains in nominal income. From my perspective, this trend is likely to continue, with aggregate farm income flat or declining as we enter the 21st century.

What does this mean for individual American farmers and ranchers? Of course it does not mean that their individual incomes will be falling, but it does mean that farm businesses will remain under considerable economic pressure. In my opinion, this pressure will only further the well-documented trends toward consolidation (fewer farms) and increasing reliance on off-farm income.

AMERICAN AGRICULTURE IS HIGHLY DEPENDENT ON EXPORT MARKETS

Just to maintain current levels of real farm income, exports must grow. Current prospects for export markets appear bright. However, in addition to the usual bumps in the road, I see a major challenge and two important question marks which I believe cloud the future of agricultural exports.

First the challenge: The structure of world agricultural trade is shifting away from bulk commodities and toward value-added and higher-valued products. Although U.S. agriculture is starting to follow these trends we remain positioned as a supplier of bulk commodities. As a nation, we have a large investment in an infrastructure oriented to bulk commodity export, and our policies remain focused on bulk commodity markets.

Next the question marks, trade policy and the global balance of demand and supply.

Our current expectations about agricultural exports assume that world trade and U.S. exports will grow as a result of trade liberalization following GATT and NAFTA. Will our optimistic view of the global trading environment come to pass? Although I remain optimistic, protectionist ideas remain alive and part of our political discourse -- as this week's primary election in New Hampshire demonstrated. There are also questions about the ability of GATT and the new World Trade Organization to discipline agricultural policy. Among others, Robert Paarlberg of Wellsley College has questioned the ability of the Uruguay Round to control future export subsidies in a recent *Choices* article.

Our expectations about export markets are also being shaped by a growing perception that the world is headed toward a food shortage. These concerns, and their effect on our outlook, are increasingly reminiscent of similar concerns in the early 1970s, which did not materialize. Both historical experience and my training in economics lead me to view suggestions that we are headed for a global food shortage with a high degree of scepticism. I do not believe that American farmers should not expect that a food shortage, even should it occur, will ensure their prosperity.

DECLINING GOVERNMENT SUPPORT AND INTERVENTION

The federal budget remains perhaps the single most important driver of U.S. agricultural policy. Although spending on farm programs and the annual federal deficit have both declined in recent years, the budget's pressure on farm programs has not abated. Nor is likely to in the future. Why?

First, there is strong political pressure to balance the budget. This pressure will continue even if the deficit falls, because the fundamental debate is as much about the size and scope of the federal government as it is about the economic implications of the deficit.

Second, real fiscal pressure will build early in the 21st century unless the large entitlement programs, Medicare and Social Security are brought under control. The political reality is that no matter how few dollars they represent, farm programs will not be exempt from cuts in an environment where the large entitlement programs are being scaled back.

As a result of budget pressure and changes in the structure of the agricultural markets, government intervention and support for agriculture have been steadily declining for over a decade. Consider the following evidence:

-- We have largely given up on supply controls as a policy instrument. No matter what the final farm bill looks like, the Acreage Reduction Program is almost certain to be eliminated.

-- The policy of tying loan rates to market prices is now firmly established, and price supports play little role in agricultural markets today. However, nonrecourse loans do continue to provide participating farmers with important financial tools for managing liquidity and risk.

-- Government stocks no longer play an important role in agricultural markets. Elimination of the Farmer Owned Reserve program is a real possibility.

-- Direct payments to farmers are declining.

Although all aspects of declining government intervention in agriculture are important to farmers, I would like to focus attention on the last two points: stocks and payments.

Today, U.S. grain stocks are at very low levels. For example, both total wheat stocks and the stocks-to-use ratio are at their lowest level since the early 1970s. Even more important than the *recent* decline in stock levels is the prospect that fundamental changes in agricultural policy will lead to permanently lower levels of stocks. As events of the past year illustrate, these low levels of stocks increase price volatility. Lower stocks coupled with dependance on export markets mean that farmers will face more volatile prices and even greater challenges managing market risk in the future.

With price volatility and market risk likely to increase, the decline of direct government payments will have various side effects. Depending on the outcome of the farm bill, the negative correlation between payments and prices is also likely to weaken. Lower levels of payments will mean that farm income is more dependent on the market. Moreover, as the value of farmers' contracts with the government declines, so will program participation. Lower participation in government programs, which provide important financial services (like risk and liquidity management tools) will mean that farmers will increasingly look to private sector providers of financial services for these tools.

WHAT DO THE REALITIES MEAN

Flat farm income, dependence on export markets, and declining government intervention and support mean that farmers will face ***continuing economic pressure*** and ***increased exposure to market risk***. Trends toward the ***consolidation*** of farms, ***integration*** (both horizontal and vertical) and the ***"industrialization"*** of farming will continue. The declining role of government will increasingly force farmers to ***look to the private sector for financial services*** once provided by the public sector.

In this environment farmers and ranchers will need access to increasingly sophisticated financial services. Financing the farm isn't just credit any more! In addition to the need for more sophisticated risk and liquidity management services, the changing structure of the farm sector will require new sources of equity capital. Agricultural production today cannot be adequately financed through the traditional vehicles of family wealth, retained earnings and debt.

Agricultural producers and financial service providers will need to find new ways to meet these in order to provide the capital and financial services which American farmers and ranchers will need to prosper in the 21st century. The evolution toward a new environment for financing agriculture is already underway. Large integrators are bringing new sources of capital and financing to the hog industry. The recent alliance between John Deere and Pioneer Hi-Bred to provide farm financing, AgriGreen, is another example of an innovation in agricultural finance. The creativity of commercial banks, Farm Credit, and other financial institutions in providing start-up capital for new value-added enterprises, like the Dakota Pasta Growers is yet another example.

As the structure and economics of agriculture continue to evolve, agricultural finance must evolve with it.

References

Paarlberg, Robert L. "Does The GATT Agreement Promote Export Subsidies" CHOICES, Fourth Quarter 1995, pp 8-12.

Food and Agricultural Policy Research Institute. FAPRI Preliminary Baseline, December, 1995, Selected Tables.