Another farm financial crisis?

By Alan Ker, Professor, FARE, and Director, Institute for the Advanced Study of Food and Agricultural Policy

“Are we heading for another farm financial crisis?”

This question framed our recent mini-conference sponsored by the Institute for the Advanced Study of Food and Agricultural Policy. More than 110 attendees were keen to hear the answer from experts, including:

- Steve Duff, OMAFRA – Current farm financial conditions
- Alfons Weersink, FARE – What does the farm financial crisis of the 1980s tell us today?
- Kenneth Poon, FARE, and Greg Pate, OMAFRA – Impact of interest rate changes on Ontario farms
- Brady Deaton, Jr., FARE – Some connections between farmland ownership, farm rent and farmland values: Implications for ag policy in Ontario
- Jean-Philippe Gervais, Farm Credit Canada (FCC) – 2015 outlook for farm cash income and asset values

Presenters drew parallels between the events leading up to the farm financial crisis of the 1980s and the current situation in Canadian agriculture. They also pointed out key differences between the two. The general consensus is optimistic – a farm financial crisis is not forthcoming.

Coverage from the conference can be found at:

- Real Agriculture: https://www.realagriculture.com/2015/05/are-we-heading-for-another-farm-financial-crisis/ and https://www.realagriculture.com/2015/06/are-large-farms-better-equipped-to-weather-an-interest-rate-hike/

I would like to extend a special thanks to our speakers for delivering insightful presentations. I would also like to thank OMAFRA for hosting the event and for helping to put the agenda together.

Lastly, and most importantly, I would like to thank everyone who attended; I hope you found the conference most worthwhile.
The rapid and steep increase in Canadian farmland values over the last decade has led some prognosticators to make gloomy comparisons to the events leading up to the farm financial crisis of the 1980s. This article provides a brief history lesson on the last time there was significant erosion in equity within the farm sector.

I’ll use 2005 for a point of reference; corn prices were in the $2 per bushel range and trending downward. In the winter of 2005/2006, farm protests gathered steam with tractors rolling down the 401, and the “Farmers Feed Cities” campaign began. Then, during a six-week period beginning at the end of September, corn prices more than doubled to over $4 per bushel. Given that prices normally fluctuated within 50 cents over the year, this was a unique situation – one not seen since the early 1970s.

Record corn prices

Prior to the early 1970s, corn prices hovered between $1.25 and $1.50 per bushel as seen in Figure 1. However, these prices doubled in late 1972 and then continued to rise to a peak of nearly $4 per bushel in early 1974. This looks similar to the recent price trends, but 1972 is 2006 and the peaks of this recent price rise is reached several years later in contrast to the sudden rise and fall in prices in the 1970s. In real terms after adjusting for inflation, the corn prices of the early 1970s are the highest farmers have ever received. Prices jumped due to significant decreases in supply and increases in demand. Supply fell because of major crop failures in 1972 and 1974. The reduction meant that some countries turned into importers including the Soviet Union, which was totally unexpected. The Cold War had isolated the Soviet Union from commodity markets but its crop failures forced it into the grain market. At the same time, energy prices were rising and this enhanced the demand for a number of developing countries, particularly those exporting oil. Malthusians claimed we had now reached a point where population increases were outpacing our ability to supply food; they predicted dire famines, diseases, and wars fought over the dwindling resource base.

Increased land value and debt

As a result of the price increases, U.S. Secretary of Agriculture, Earl Butz, famously proclaimed in 1973 that farmers should “plant fence row to fence row.” The rapid rise in price and the view that this was the ‘new normal,’ as evidenced by Butz’s statement, led to increases in land values and debt levels. Land value rose dramatically, largely because land became priced as a growth stock. In other words, the increase was not only due to an increase in annual returns but also the expectation that its future annual returns were going to increase along with its future resale value. In order for land to maintain its price, real earning growth was necessary.

“... the corn prices of the early 1970s are the highest farmers have ever received.”
Debt levels increased at the same rate as land values. It was easy to get credit to finance the purchase of land and other assets. Not long before this, access to credit was a problem for farmers; it was the reason Farm Credit Corporation (FCC) was established. But now all lending institutions wanted to be part of the game and invest in agriculture. Lending policies were based on asset value rather than repayment capacity. Given the rapid rise in asset values, there was no perceived risk to the lender.

In the 1980s, the fortunes of the sector completely reversed. Prices had started to fall in the late 1970s to around $2.50 per bushel, which is what would become the actual new norm for the next 30 years and not the projected new norm of $4 per bushel a few years earlier. Farmers responded to Earl Butz’s plea and stock levels increased. The supply increase was enhanced by farm support policies that stabilized prices.

Large and unexpected increase in interest rates

After the initial price rise in the early 1970s, prices fell steadily with fluctuations but no dramatic swings. What did change dramatically, however, were interest rates. In late 1979, Paul Volcker, Chairman of the U.S. Federal Reserve, unexpectedly put the brakes on money supply in an effort to control inflation. Even though the inflation rate was in the double digits, the general sense was that single-digit interest rates would continue. Instead, what were negative real interest rates became record high rates in a very short period. As shown in Figure 2, Canada’s prime lending rate essentially doubled in the space of a year to a peak of 22.7% in 1981.

The large and unexpected increase in interest rates was the straw that broke the camel’s back. We went from a period of extreme optimism in the early 1970s that led to high levels of debt based on asset financing. The sector was subsequently vulnerable to negative shocks and those shocks came less than a decade later in the form of lower prices, and especially higher interest rates.

Rise in farm bankruptcies

The net effect of a highly leveraged sector facing lower returns and higher borrowing costs was a rapid rise in farm bankruptcies. In 1979, there were 125 farm bankruptcies nationally, but the average was in the high 400s during the 1980s with a high of 551 in 1984. In contrast, there were 45 in 2012, and 66 in 2013. The bankruptcies were a reflection of the pressures faced by most in the sector and the period became known as the ‘Farm Financial Crisis.’

This is the first of two articles about the farm financial crisis. In a future issue of FARE Share, Alfons will discuss similarities and differences in the agricultural sector between the 1970s and the last decade.

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Impact of rising interest rates

By: Kenneth Poon, Associate Director, Institute for the Advanced Study of Food and Agricultural Policy, and Greg Pate, Economic Policy Analyst, OMAFRA

Canadian farm debt has more than doubled since 2000 – to $84.42 billion in 2014. With rising farmland prices, recent media coverage has raised questions about farmers’ ability to meet debt obligations, and their sensitivity to changing market conditions. In particular, is a specific group of farmers more at risk of meeting farm debt obligations than others? This is a pertinent question, since interest rates have nowhere to go but up in the near future.

Coverage ratios indicate financial health

We set out answering these questions using the Ontario Farm Income Database, a collection of revenue and expense data on all tax-filing farms in Ontario. Our investigation focuses on the interest coverage ratio – an operation’s net farm income (revenue minus expenses) divided by interest expense – to determine how easily a farm can pay interest on outstanding debt in 2013, the latest year for which data is available. (See chart on next page.)

Typically, a lender considers an operation to be in good financial health if the coverage ratio is at or above 1.3 (the business’s net income is 30% above the annual interest they are obligated to pay back to the lender).

We found that the majority of farm debt (proxied by interest expense) in Ontario is held by a small number of large commercial farms (greater than $1 million in farm cash receipts). The majority (>95%) of these farms paid $109,455 in interest expense, on average, in 2013, just under three times the average interest expense reported by the next largest size category ($500,000 to $1 million in sales). What’s more, these large farms have healthy cash flow – more than 85% have positive net income.

Pay attention to net farm income rather than interest rates

Our results show that net farm income, rather than interest rate, is the major determinant of a farm’s ability to meet their farm debt obligations. There are only a few farms – less than 8.4% of all farms in 2013 – carrying debt with ‘poor’ interest coverage ratios (i.e., between 0 to 1.3). A more interesting group is those with interest payment obligations and with negative net farm income, which made up about 22.6% of farms in our sample. More than half of the farms with negative net income are small-scale operations with less than $100,000 in sales and averaged $6,115 in interest payments. There is a small share of very large commercial operations with negative net farm income and high levels of interest payments.

With low interest rates in recent years, even a modest rise of 3% over the next two years is not expected to impact the farm sector’s ability to pay their debt. Rather, due attention should be paid to net farm income, which is projected to fall with rising input prices and stable commodity prices. This can lead to more operations reporting negative net income and impacting their ability to meet their debt obligations.

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The last five years have been a period of unprecedented strength for Ontario agriculture from a farm cash receipts, aggregate net income and net worth perspective. Many individual farms continue to experience historically high cash flows, despite an easing of grains and oilseeds prices. Average net farm incomes and farm family incomes have risen sharply since 2009 and should stay at near historically high levels for the near term. For many, off-farm income is providing a base for small, niche-focused farm ventures. The size and scale of the very largest farms continues to grow but, even within this group, some struggle with profitability. Softening grains and oilseeds prices will continue to squeeze margins of many farms. Strong cash flows and net incomes have driven producers to acquire assets – land in particular – and retain earnings. Dairy and poultry farms continue to outpace non-supply managed farms in terms of income and net worth. Financial ratios are improving, but a decline in farmland values may stress the balance sheets of many farms – especially ones that are leveraged against land.

“The majority of farm debt in Ontario is held by a small number of large commercial farms (greater than $1 million in farm cash receipts).”
Questioning farmland ownership

By: Brady Deaton, Jr., Professor, FARE

Increasingly, I am asked questions about foreign ownership of farmland in Canada. My response is to raise five key questions that deserve consideration and future research.

1. What proportion of Canadian farmland owners are from other countries?

In Canada, the percentage of foreign ownership of farmland is likely small. In a 2013 survey that my colleagues and I conducted in Ontario, farmers identified approximately 1% of their landlords as “foreign.” In this survey, 207 Ontario farmers were asked questions about the largest parcel of farmland they rented. Only two of the farmers, 1%, indicated that their landlord was based outside of Canada.

While this is based on survey responses, and more research will be needed before we can generalize with confidence, the small percentage of landlords identified as being based outside of Canada undermines some current conventional thinking about the extent of foreign-owned land.

Interestingly, this small percentage parallels foreign ownership of farmland in the United States. According to the United States Department of Agriculture, less than 2% of U.S. forest and farmland is owned by foreign investors.

2. What is the investor origin of foreign ownership of farmland in Canada?

Unfortunately, no Canada-specific data exists, so the answer cannot be given with certainty. It’s a question, however, that we should be open-minded about regarding the premature concern it could raise. I say this because Canadians are often surprised to learn that Canadians are the largest foreign owner of forest and farmland in the United States. According to the United States Department of Agriculture, less than 2% of U.S. forest and farmland is owned by foreign investors.

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3. What percentage of Canadian farmland is rented?

A great deal of Canadian farmland, close to 40%, is rented or leased.

4. Is most of this rented land owned by active farmers?

My research in Ontario suggests that most of this rented farmland is not owned by working “farmers,” although much of it is owned by the heirs of former farmers. The bottom line is that the overwhelming percentage of non-farmer owners of farmland are Canadians; investment in farmland and speculation on farmland values appears to be of far more interest to Canadians than foreigners.

5. Who is involved in farmland transactions in a market setting?

Conceptually, there are buyers and sellers making mutually beneficial transactions. The magnitude and distribution of these benefits depend, in part, on government policy. Policies that disallow certain buyers – e.g., a policy that disallows foreign ownership of Canadian farmland – generate winners and losers. (Such a policy does not exist in Ontario but does exist, in varying degrees, in other provinces.) To the extent that a foreign investor would be the highest bidder, the losers are the foreign investor and the seller of the farmland, in many cases Canadian farmers. The foreign investor becomes a loser because the policy diminishes the opportunities to enter into a desired exchange. The seller of farmland becomes a loser because he/she doesn’t realize the potentially higher bid.

Such a policy does generate some winners. For example, the highest domestic bidder will now receive the farmland. That bidder, perforce of policy, will be Canadian; though, not necessarily a farmer.

Why do all these questions matter? They matter because answers to them inform our decision-making. When those answers are data driven, they can enlighten public policy. When they are speculative, or, driven by the loudest voices, they can mislead.

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Recently, there has been much speculation about the investor origin of farmland purchases in Africa. There are reports that large portions of many countries in Africa are experiencing “land grabs.” And though it is commonly thought that Asian countries have been purchasing large portions of farmland in Sub-Saharan Africa, whether by “land grabs” or not, a recent empirical assessment of this issue in *Food Policy*, found that the United Kingdom and the U.S. were the largest investors in Sub-Saharan Africa farmland between 2005 and 2013. From a regional perspective, Europe was the largest investor during this time period.
Professor Deaton has asked, and at least partially answered, five important questions about foreign land ownership in Canada. His article caused me to reflect on further questions where answers are more ambiguous, politically sensitive and worthy of analysis.

**Does it matter who owns farmland?**

First, there is an old cliché in agriculture that, “farmers live poor, and die rich.” The reason farmers die rich is that a farmer’s wealth consists largely of the value of their land. Farmers who have owned land for 30 to 40 years can generally cash-out with a very nice nest egg for retirement. However, with 40% of farmland now rented, does it change the last part of this old adage? Clearly, 100% land ownership provides a bigger retirement fund than 60%, but with commercial farms getting bigger their net worth is still substantial. Statistics Canada reports that, in 2013, the average net worth (assets minus liabilities) of farmers with over $25,000 in sales was $2.3 million in Canada and $2.4 million in Ontario. So, a more accurate modern adage might be “farmers live reasonable, and die well off.” Still, if farmland ownership falls far enough, farmers become much like other Canadians who need to save for retirement from current income. What level of ownership is this and should policy makers be concerned?

**Do tenants farm rented land in the same way they farm the land they own?**

If tenants abuse rented land then there is cause for concern. However, recent work by Professor Deaton and colleagues suggests that farmers with long-term leases generally treat rented land the same way as their own. If it turns out that the type of landlord influences this responsiveness, then there may be a need for policy that addresses this issue.

**Is a farm with rented land more or less risky than a farm that owns all of its land?**

This is an important question because almost all public policy focused on agriculture is justified by the “risky” nature of farming. No one has said it much better than the esteemed agricultural economist Vernon Ruttan who wrote in 1969: “The rationale for public intervention in agricultural commodity markets is, and will continue to be, ...to lend stability to an industry which technological and economic forces should render chronically unstable in the absence of such intervention.”

Forty years ago, government financial support for agriculture was a small fraction of what it is today and a key method of handling risk was through mixed farming, literally “Old McDonald’s Farm.” If things were tough in corn, profits in hogs would be higher. While mixed farms still exist, many farms are specialized in cash crops or a specific type of livestock production. Government programs have been established to reduce risk through individual farm income support programs, subsidized savings programs, and vastly expanded crop insurance programs.

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— Vernon Ruttan, ag economist

Where does farm ownership fit into all this? It might help to consider two identical cash crop farms – one that owns all of its own land, and one that rents all of its land. When crop prices drop substantially the farmer who owns all of their own land can survive the trough by borrowing against their equity in land; and the farmer who owns no land does it by renegotiating their rental payments. It is not obvious to me which of these options is less risky. My guess is that commercial farmers are rather sophisticated portfolio managers and the best option is neither full ownership nor no ownership but in fact partial ownership. If so, has the invisible hand of the market led to the optimal degree of land ownership by both farmers and non-farmers?

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1 The first part of this statement “live poor” was true for many years but it is no longer correct. Canadian farmers now earn family incomes that are equivalent to non-farmers.
Not heading for another farm financial crisis

By Jean-Philippe Gervais, Chief Agricultural Economist, Farm Credit Canada (FCC)

Concern around debt is hardly new. Canadian consumer debt – totaling more than $1.8-trillion as of April 1, 2015 – has sounded alarm bells. Canada’s farm debt has also grown to record levels. Between 2005 and 2014, Canada’s overall farm debt grew 68% to more than $84 billion, prompting discussion and concern for the financial health of the sector. For one thing, producers and consumers should get ready to face higher interest rates down the road. While nobody knows exactly when they’ll start to climb, interest rates are bound to increase.

But that’s where meaningful comparisons between consumer and farm debt end.

Canadian farm debt climbed at a time when the overall farm economy boomed. Net cash income at the farm level increased from $6.8 billion in 2005 to $13.9 billion in 2014. Early indications suggest net cash income is likely to be around $13 billion in 2015 driven by a strong cattle market, and softer grain and oilseed prices.

The ratio of farm debt to net cash income has been on a declining trend since 2006, suggesting an improvement in the ability of producers to meet their debt obligations.

Farm asset values have also climbed in recent years, driven by rapid increases in farmland values. While risks exist in some Canadian regions where farmland is highly priced and where prices have climbed rapidly recently, overall market values of farmland seem in line with the fundamentals of the marketplace.

Canada isn’t headed for another farm financial crisis. The underlying drivers of the farm sector paint a positive – if cautionary – picture of the farm economy.

“Canadian agriculture has a strong economic outlook, even though prices are likely to be off their recent highs.”