

Statement of

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Before the

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Subcommittee on Agriculture, Rural Development, Food and Drug Administration,
and Related Agencies

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Thank you, Mr. Chairman and members of the subcommittee, for the invitation to participate in today's roundtable discussion on economic conditions in the U.S. farm sector. My name is Nathan Kauffman, and I am assistant vice president and economist at the Federal Reserve Bank of Kansas City, a regional Reserve Bank that has long devoted significant attention to U.S. agriculture. The economy of our Reserve Bank's district, which includes all or parts of Missouri, Nebraska, Kansas, Oklahoma, Colorado, Wyoming and New Mexico, has a high concentration of agriculture, and I lead several efforts at our Bank to track the agricultural and rural economy at both a regional and national level. These efforts include a regional agricultural credit survey of commercial banks in our district, the Federal Reserve System's Agricultural Finance Databook, which is a national survey of agricultural lending activity at commercial banks, as well as other research and ongoing outreach efforts. I will be sharing with you today, information on recent developments in the agricultural economy, with an emphasis on agricultural credit and lending conditions. Before I begin, let me emphasize that my statement represents my views only, which are not necessarily those of the Federal Reserve System or any of its representatives.

Farm Income Conditions

Following multiple consecutive years of strong incomes in the farm sector, farm income has steadily weakened the past few years and is expected to remain low in the coming months. According to the U.S. Department of Agriculture, net farm income in 2015 was forecasted to be more than 50 percent less than in 2013, and the forecast for 2016 is for an additional modest decline (Chart 1). Regional Federal Reserve surveys of agricultural banks, both in the Kansas City Fed District and nationally, paint a similar picture. Most bankers expect farm income to remain low through 2016 and have expressed increasing concern about the potential implications of this development.

The drop in farm income since 2013 has been primarily due to significant declines in the prices of major U.S. row crops. Corn prices, for example, dropped by more than 50 percent from the peak in 2012 to the latter part of 2014. Since 2014, prices have fluctuated some, but have largely remained flat over the past 18 months. Soybean prices also dropped significantly from

2012 to 2014 and have continued to fall over the past year. The prices for other major crops, such as wheat, sorghum and rice, have experienced similar declines in varying degrees. Input costs for crop production have declined somewhat over the past 12 to 18 months due to lower fuel costs and modest reductions in fertilizer prices. However, costs have generally remained high, and many producers have continued to report negative profit margins, with crop prices below their breakeven cost of production.

In the latter part of 2015, sharp losses in some segments of the livestock sector have exacerbated the sense of pessimism in the U.S. agricultural economy. From peak levels around the beginning of 2015, cattle prices had dropped by about 25 percent by the end of the year. Hog prices have declined by a similar amount, and milk prices have also continued to drift lower. Although cow-calf operations have generally remained profitable, some cattle feedlot operators reported losses of up to \$500 per head several months ago, and profitability in other segments of the livestock sector generally have also worsened over the past year.

Agricultural Credit Conditions

The persistent declines in farm income and poor profit margins have reduced cash flow and increased short-term lending needs in the farm sector. The Federal Reserve's Agricultural Finance Databook shows that the volume of new, short-term farm loan originations at commercial banks increased more than 50 percent from 2012 through 2015 (Chart 2). These loans are primarily operating loans, used to finance ongoing expenses required for production. This development is particularly concerning because it has occurred during a time when farm income has been roughly cut in half, raising significant concerns about the debt service capacity of farm borrowers for the coming year.

Similarly, agricultural credit conditions have also steadily weakened over the course of the downturn in the agricultural economy. Data from Kansas City Fed surveys of agricultural banks in our seven-state region show that loan repayment rates have declined in each of the past nine quarters, with the sharpest change reported in the most recent survey in the fourth quarter of 2015 (Chart 3). Moreover, bankers expect repayment rates to weaken further in the coming months amid further increases in loan demand and increasing demand for loan renewals and

extensions. Bankers have also indicated that credit availability has tightened somewhat in recent months alongside farm borrowers' heightened demand for credit to finance their operations.

Despite the softening credit conditions, delinquency rates for both real estate and non-real estate farm loans have remained historically low. In the fourth quarter of 2015, the delinquency rate on farm real estate loans was only 1.5 percent, compared with 3.6 percent five years ago, and was significantly less than the delinquency rate on residential real estate loans in the fourth quarter (Chart 4). Similarly, delinquency rates on agricultural production loans have declined over the past five years from 2.7 percent to less than 1 percent. Although delinquency rates have remained low, it is important to note that many lenders have indicated that the strong incomes of previous years, combined with low interest rates, have kept loan performance strong during the recent downturn (Chart 5). However, significant working capital deterioration in 2015 has placed many borrowers in a more precarious financial position this year. If the current environment of low farm incomes persists through 2016, lenders generally expect to see loan performance deteriorate through the year.

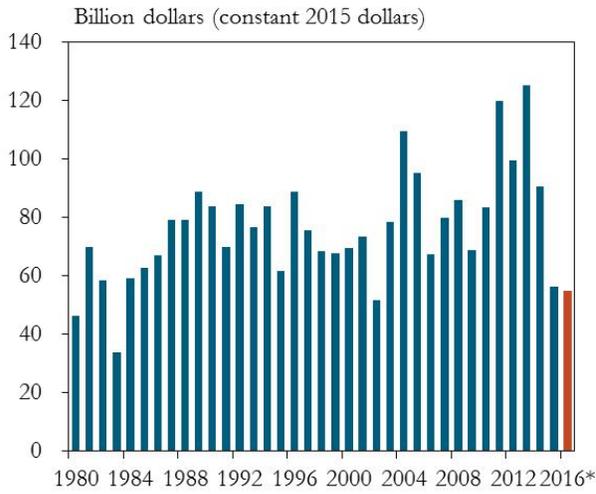
Although farm income has dropped considerably, farmland values have declined at a more modest pace. In the Kansas City Fed District, for example, the average value of high quality cropland has declined in each of the past four quarters, but by less than 5 percent in each quarter relative to the previous year (Chart 6). Farmland values are an important part of the health of balance sheets in the farm sector. The fact that farmland values have remained relatively strong has helped support the overall financial position of many farm borrowers. Nevertheless, our survey data also show that farmland values are expected to continue to soften over the next year alongside lower incomes in the sector.

Conclusion

To summarize, the recent downturn in the agricultural economy has continued to intensify over the past year. Barring significant increases in agricultural commodity prices in the coming months, which seem unlikely based on current market fundamentals, the sharp drop in farm income last year appears likely to persist through 2016. Although outright defaults in the farm sector have been limited to date, it is possible that financial stress among farm borrowers

could increase through the year. This could further weaken agricultural credit conditions and also place additional pressure on farmland values. As a result, some producers, particularly those who are highly leveraged, could face difficulty financing their operations in the coming year.

Chart 1a: U.S. Real Net Farm Income



Sources: USDA and Federal Reserve Bank of Kansas City.
* Forecast for 2016.

Chart 1b: Tenth District Farm Income

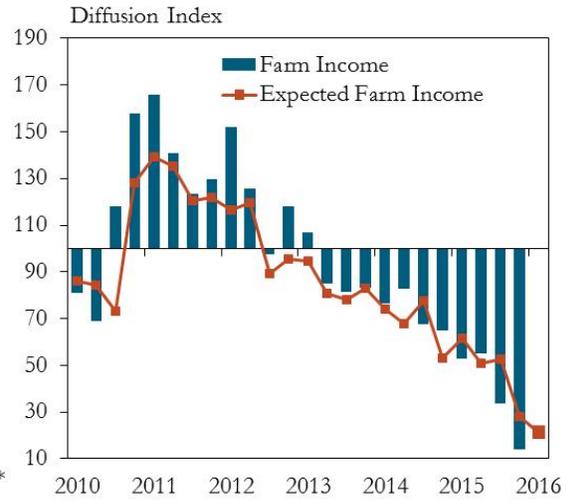
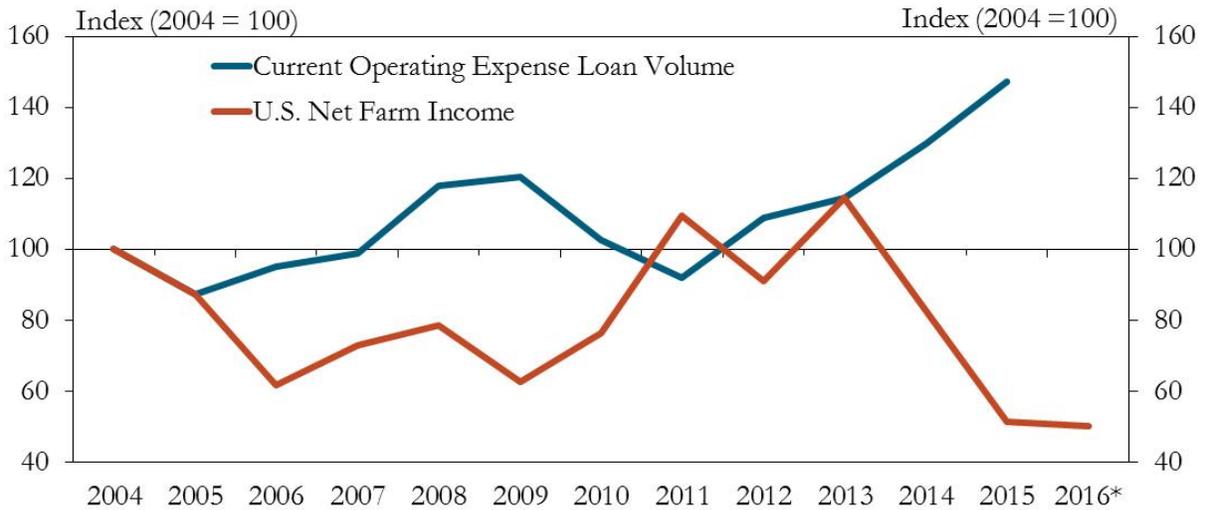
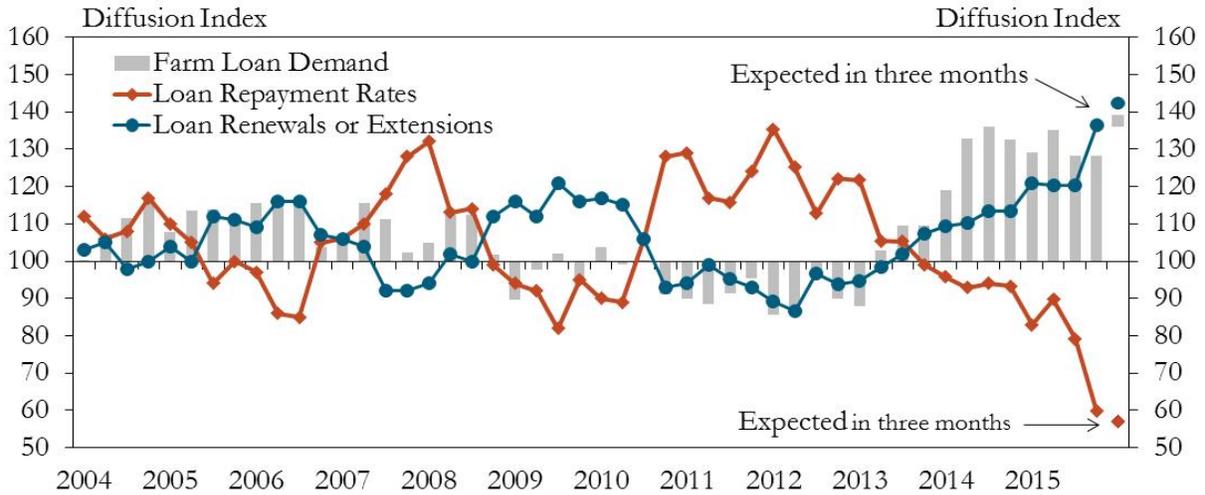


Chart 2: U.S. Farm Income and Operating Loans



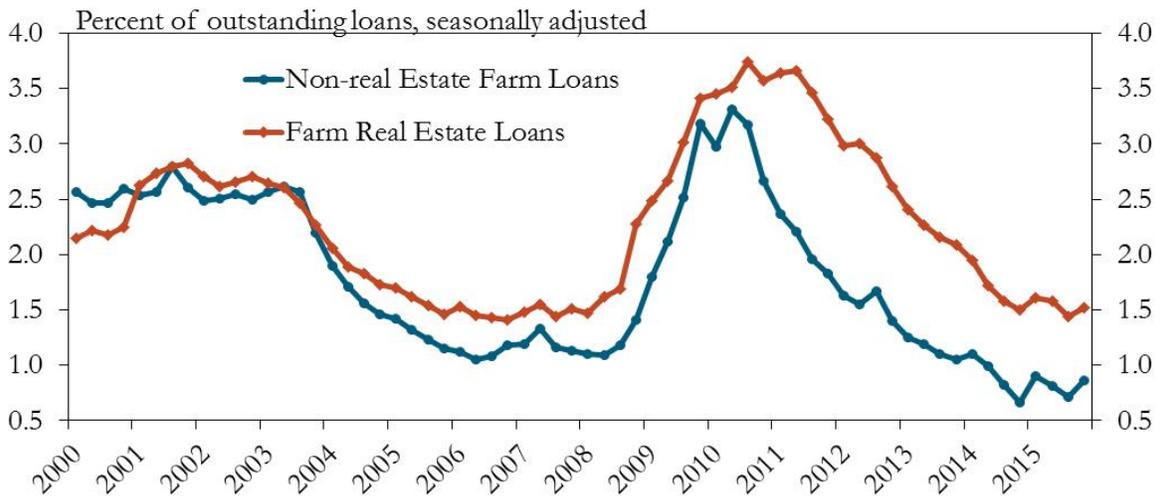
Sources: Agricultural Finance Databook Table A.3 and USDA.

Chart 3: Tenth District Credit Conditions
2015, Fourth Quarter



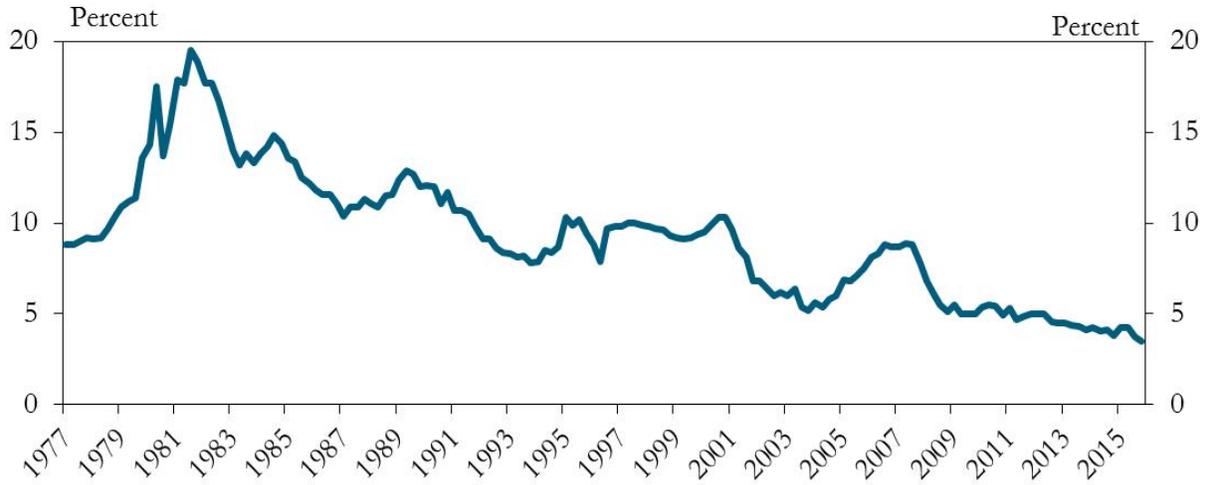
Source: Federal Reserve Bank of Kansas City, Survey of Ag Credit Conditions

Chart 4: U.S. Farm Loan Delinquency Rates



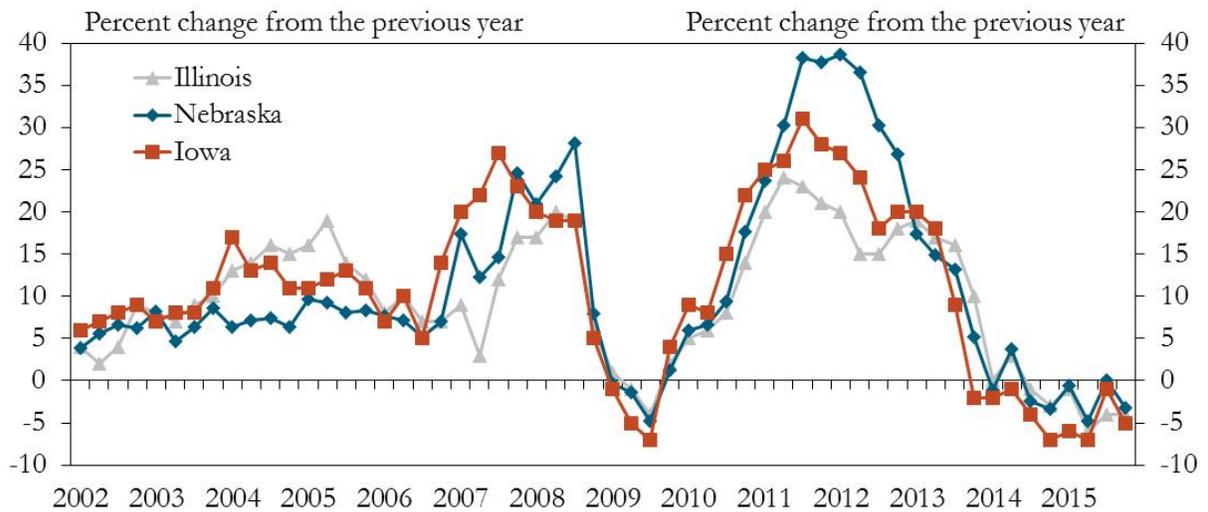
Source: Federal Reserve Board of Governors

Chart 5: Average Effective Interest Rate on Non-Real Estate Commercial Bank Loans



Source: Federal Reserve Bank of Kansas City, Agricultural Finance Databook

Chart 6: Changes in High Quality Farmland Values



Source: Federal Reserve Banks of Kansas City and Chicago.