

# Managing Farm Finances in the 1980s

Farm financial strategies that often paid handsomely during the 1970s may lead to trouble in the 1980s. During much of the 1970s, farmers who borrowed heavily to expand their farms reaped large financial rewards. Today, however, such a strategy would likely result in lower returns and possible bankruptcy, according to an article written by Economic Research Service economists for USDA's Agricultural Outlook magazine.

Strategies of the 1970s are less applicable now because the rate of inflation has slowed, interest rates have risen, and the value of farmland has declined. To boost returns in the early 1980s, many farmers are paying more attention to risk and current cash flow than to capital gains on assets purchased through borrowing.

Successful farming depends not **only** on proper management of production and marketing decisions, but also on sound financial management—farm expansion plans, credit use, land rent or purchase decisions, tax planning and exposure to financial risks. In fact, as the experience of the last decade has shown, farm financial management is at least as important as production and marketing to farmer's economic well-being.

The key variables in planning a farm financial strategy are:

- the expected rate of return from current income and capital gains,
- the farm's cash flow (current cash income minus expenditures) and
- the degree of risk of low returns from current income, low or negative capital gains, or severe cash-flow problems.

Rates of return and cash flows are not the same thing. Farmers and farm investors receive returns from two sources: Current income from the operation of owned or leased farm assets, and capital gains from changes in the value of owned assets. Taken together, these determine the rate of return from farming.

Cash flow, on the other hand, is the difference between current cash income and current cash expenditures (which include principal payments). It can be positive or negative regardless of the rate of return. The farmer's exposure to risks—poor rates of return, negative cash flows, or even forced liquidation—is largely linked to the financial management strategy the farmer adopts.

To illustrate the rate of return and cash flow, the economists analyzed a hypothetical but representative Mississippi Delta cotton-soybean farm of 1,040 acres with two levels of debt in 1979-81. Use of debt financing increased the rate of return to equity in 1979, was neutral in 1980, and decreased return to equity in 1981. Debt also reduces cash flow and can make it negative, as in 1981.

Negative cash flows in 1980 were more than offset by capital gains, the usual situation through most of the 1970s. But with the recent decline in farmland values and lower inflation, farmers can no longer count on such an automatic adjustment.

Exposure to risk is the third important key to farm financial management. Although heavy use of debt financing can result in higher real rates of return to equity in favorable years—as in 1979—it exposes the farm to potentially severe cash-flow problems, as interest and principal payments can exceed net cash farm income. The risks are not symmetrical, however; if a farm remains debt-free, it is merely foregoing the return possible from some added investment in favorable years; but if the farm uses too much debt, it could face foreclosure or loss of assets in a bad year. The risk of foregone returns depends on the rate of return, and the risk of asset loss depends on the cash flows.

When the rate of inflation in the economy changes, the three variables in planning a financial strategy—rate of return, cash flow and risk—become four. Rate of return on indebted assets must be adjusted for the effects of inflation by comparing real rates of return with real interest rates. (For complete accuracy in planning, real rates of return and real interest rates would be adjusted for income taxes that would be saved.)

For the farm sector as a whole, the 1970s was a period in which expansionary farm financial strategies paid off. Combined real (inflation-adjusted) returns from current income and capital gains exceeded the real interest rate, leaving a positive net return on debt-financed expansion.

Cash flow, however, depends on current income (which excludes capital gains) and current expenditures (which include principal payments and interest payments at the nominal interest rate). While some farmers with substantial debts had negative cash flows in the 1970s, lenders were generally willing to refinance such farmers because their assets had risen in value and their overall rates of return were favorable.

The picture has changed in recent years. At the moment, the most favorable financial strategies are much less expansionary, involve less reliance on debt financing, and avoid exposure to cash-flow shortages. Real rates of return on farm assets have declined sharply over the past two years, and real interest rates have risen—producing losses on indebted assets (although debt-free assets have continued to earn a normal current income).

Lenders are now less willing to refinance farmers with negative cash flows because their asset values are no longer increasing.

During the rest of 1982 and 1983, farmers likely will continue to face low crop prices, reduced rates of return, high real interest rates and cash-flow problems.

Farmers and farm investors cannot quickly adjust their debts and assets when economic conditions change, nor can they easily anticipate when such a change is imminent. Clearly, hindsight suggests the time to switch from an expansionary to a conservative financial strategy was about 1978 or 1978, when farmers could have reduced their debts before the 1981-82 period.

The time to switch back to a more expansionary strategy will be just as difficult to anticipate. Those farmers who were hesitant to make large changes in the late 1970s—and hence have little debt—may be in the best position to purchase farm assets at bargain prices when prospects start to brighten.

Despite the difficulties of forecasting the economic environment of the farm sector in the 1980s, some changes look relatively permanent. First, the persistent high inflation that characterized the 1970s is slowing down, implying that gains in the value of farmland will no longer come as automatically as in the 1970s. Land values may recover and start to increase again in coming years, but their growth will likely be weaker and less predictable than in the 1970s. This change would favor a more conservative financial strategy, because capital gains would be smaller and more variable.

Second, at least in the early 1980s, interest rates required by savers and lenders will be higher and more volatile than during the last decade—reflecting the Federal Reserve System's decision in 1979 to control and restrict the growth of the Nation's money supply, rather than enforce bounds on interest rates. The result is interest rates will adjust more readily to account for expected inflation, making negative real interest rates less likely in the future.

The Depository Institution Deregulation and Monetary Control Act of 1980 further altered the relationship between borrowers and lenders, especially in rural areas. Until the passage of this act, rural credit markets remained somewhat insulated from national monetary conditions. Throughout much of the 1970s, the farm sector had access to credit at more favorable rates than did other industries. This advantage is likely to be reduced in the 1980s.

Also, U.S. farmers' increased reliance on foreign markets and, consequently, on foreign demand is likely to continue, resulting in unstable prices. Many of the international customers for U.S. farm products have centralized governmental trading or highly protectionist policies. As a result, U.S. farm prices are now subject to large changes depending on the purchasing decisions of foreign nations.

Finally, if agricultural policy relies more on markets, more of the price and income risk will return to the private sector—farmers, investors and lenders.

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