

Can Continuation of GSE Status for The Farm Credit System Be Justified?

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This article reviews the development of the Farm Credit System (FCS) as a government sponsored source of credit for American agriculture. The main objective of the paper is to assess the arguments for and against continued status of the FCS as a Government Sponsored Enterprise (GSE). While agriculture is now a minor sector of the U.S. economy and there is considerable competition for the FCS from other lenders it still may be possible to argue that there is some ongoing need for GSE status, particularly if its mandate is expanded to include nonagricultural credit needs in rural America.

Developing this rationale requires a different set of arguments about the structure of capital markets in rural areas than were considered in the 1930s. Although credit market imperfections are no longer as clear cut as in the past, nonetheless they may still act as an impediment to a desirable allocation of capital. Consequently a GSE with a clearly defined focus may be a relatively efficient form of government intervention that can enhance capital flows in rural areas.

The Context

The Farm Credit System occupies a unique position in the spectrum of Government Sponsored Enterprises. Not only was it the first GSE, with origins in 1916, but it is also the only GSE that is organized as a cooperative rather than an investor-owned firm, and by virtue of the client group it serves it is geographically restricted to rural areas. Finally the Farm Credit System is also a GSE where it is plausible to make the argument that its original public purpose or mandate has been met, which raises questions about the necessity of its ongoing existence. The argument of the article is that these features are central in thinking about a rationale for the continued status of the Farm Credit System as a GSE.

Maintenance of GSE status is arguably more important for the survival of the Farm Credit System than for other GSEs, since the System is restricted to serving a single relatively high risk sector. This makes its financial performance highly dependent on the financial condition of agriculture. Studies conducted in the late 1980s suggested that absent GSE status, FCS bonds would not be considered investment grade, even though at the time of the study agriculture was experiencing a period of relative prosperity (Secretary of the Treasury). Higher borrowing costs would translate into higher lending costs which could make the Farm Credit System

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too high a cost lender to be viable. Yet preserving the viability of the FCS is certainly not an adequate reason for maintaining its GSE status - some more substantial public purpose is required. Given various studies that suggest commercial agriculture in the United States is not facing credit shortfalls, preserving the continued access to GSE status requires some thought about the public purpose the Farm Credit System serves.

At the turn of the last century farming was the dominant occupation in rural American and rural Americans made up over half of the national population (Figure 1). At the time agriculture faced major problems in gaining access to credit. This was widely seen as limiting not only the technological development of the agricultural sector, but also of the United States since farming was such a major source of income, employment and export revenue (Cochrane, p. 289-292). At the time the supply of both short and long term credit was unreliable and commercial banks in rural areas were both scarce in number and unprepared to advance funds to farmers at rates or durations that were consistent with the development of the sector. When credit from commercial banks was available it was at high interest rates and for short periods. These conditions were not restricted just to agriculture - all rural businesses and residents faced similar problems, but because agriculture was the dominant industry it faced the greatest problems.

The initial structure of the FCS reflected the 1908 report on the results of an examination of agricultural credit institutions in Europe by the members of the Country Life Commission. They saw the German *Landschaften* societies as a model for providing agricultural credit (Hoag, p. 65-71) that could resolve the political pressures raised by farmers demanding a solution to their financing problems. In 1916 the Federal Farm Loan Act created the Federal Land Banks and the cooperatively owned Land Bank Associations as the first element of the System to provide a long term source of funds for the purchase of land. In 1923 the Federal Intermediate Credit Banks were established to provide various types of lenders, including commercial banks, with a facility to discount short to medium term loans to farmers.

In 1933 the Emergency Credit Act recapitalized the Federal Land Banks and gave them authority to refinance the debts owed to other commercial lenders. By 1933 bank participation in lending to farmers had diminished to a point that Production Credit Associations and the Banks for Cooperatives were established through the Farm Credit Act of 1933 to provide a mechanism for farmers to obtain financing for production credit and to operate supply and marketing cooperatives. These changes established a structure for the Farm Credit System that remained in place through 1987.

The most important features of the reconstituted FCS were its cooperative nature and the restriction on its charter. Individual Production Credit Associations and Federal Land Bank Associations were established with defined territorial service areas and they in turn owned the district Intermediate Credit and Land Banks. The cooperative structure had two important features - the first being an inverted ownership/control structure and the second the requirement that owners must be

borrowers. Unlike most business organizations the FCS is ultimately governed from the bottom up. Farmers elect local association boards of directors, which in turn elect the boards of directors which control the Banks. In practice the flow of information and management decisions comes from the top down, but there is an ultimate responsibility of the banks to be accountable to the associations.

More important is the ownership restriction inherent in a cooperative. Only members of the cooperative can borrow from it and members own shares in the cooperative in proportion to the volume of borrowing they do. One implication of this structure is that there is no incentive for the FCS to maximize profits. An investor owned firm is able to separate the interests of the owners of the firm, the stock-holders, from the interests of its customers. For the cooperative not only are the two groups identical but since shares of profits are proportional to the volume of business generated by each member there is no strong incentive for a cooperative to generate accounting profits because they can only be repatriated to the owner/borrowers in proportion to the amount that each previously contributed to the business. Certainly there is an incentive to capitalize the FCS through retained earnings to a level that provides protection against contingencies, both in terms of asset quality and interest rate shocks, but because there is no wedge between ownership and use, the normal incentive to extract profit is not present².

To ensure that the Farm Credit System met its public purpose, providing funding to American agriculture, its charter was restricted to serving the needs of farmers and ranchers. Subsequently some expansions of authority have been allowed, to serve the fishing industry, some types of rural housing and to finance rural infrastructure; but each of these extensions is limited in scope and does not provide enough new authority to significantly reduce the incentive to serve farmers.

During the 1940s the loan volume of the Farm Credit System expanded and its share of farm sector debt expanded (Figure 2). However by the middle of the century competition from commercial banks began to increase as the aggregate demand for credit expanded. Increases in FCS loan volume no longer resulted in parallel increases in market share. This suggests evidence of improvements in the efficiency of capital markets. Other evidence includes a declining role played by individuals in financing farm credit. Formal intermediaries greatly increased their share of the market (Figure 2). All this suggested that the FCS was successful both in terms of directly meeting the credit needs of farmers and in demonstrating to other lenders that lending to farmers was a potential profitable activity.

Because the Farm Credit System appeared to be meeting its objectives, it became a prototype for other GSE's in housing, and later student loans. However in the

² Some parts of the FCS have used retained earnings to develop an allocated surplus fund that is used to provide patronage dividends to members. While members are essentially paying themselves the use of patronage can be justified as a device to increase the members' support for the association. Because the borrower has an investment as well as a loan there is a stronger incentive to participate in the association and to try to maintain the viability of the organization.

creation of the new GSEs, major changes were made from the FCS model. They were not organized as cooperatives and they do not directly deal with individuals, instead they work through existing financial intermediaries and are owned by investors. These differences are important, because unlike the FCS the other GSEs have a strong incentive to act in the interests of their owners and not the users of their services. Despite the much larger size of the housing and student loan market the FCS remained the largest GSE in terms of loan volume outstanding until the mid 1970s.

The Future of the Farm Credit System

Analysis of the future role of the Farm Credit System must start from the consideration of the features of the System that characterize it. These features fundamentally set the goals, capacities and constraints of the FCS. While they are subject to change, change can only be initiated by forces external to the FCS; so in a sense the basic characteristics are really a set of constraints under which the System operates.

Four main features define the FCS. These four aspects of the System are important in understanding its past development, its present condition and its future potential. They are;

- **the cooperative nature of the Farm Credit System,**
- **its Congressionally mandated role as provider of credit to American farmers,**
- **its status as a Government Sponsored Enterprise (GSE), and**
- **its organization as a financial intermediary operating as a portfolio lender.**

Each of the features imposes important limits and behavioral patterns on the FCS, and most importantly, each of these features is in part a reflection of the evolving will of the Congress as it determined the structure of the System over the last eighty years.

The four basic characteristics are strongly related. In a sense they are complements to each other. Status as a GSE was provided by the government to allow the FCS to gain access to national capital markets so it could provide agriculture with a stable supply of funds. Similarly a cooperative structure helps to ensure a focus on agriculture, since the owners of the enterprise are concerned with agricultural lending. As a portfolio lender the FCS retains a significant amount of the risk that stems from its lending practices, and in principle that should make the farmer/owners of the FCS more prudent in their lending decisions, since they face the first round of losses. A Congressional charter allows oversight and control of the institution's practices, providing a means of protecting the government from the potential risk associated with GSE status for the FCS.

Origins and Evolution of the Farm Credit System

As noted earlier the failed development of credit markets in rural areas was the cause of the creation of the first elements of the Farm Credit System in 1916. Farm losses of the 1920s and 1930s were a precursor to those of the 1980s; showing that the health of the FCS was critically dependent on conditions in agriculture. During the 1920s as the agricultural recession began, credit in agriculture shrank rapidly. By 1933 the initial capital of the Federal Land Banks was exhausted; and in a series of legislative initiatives President Roosevelt asked the Congress to pass legislation that established the Farm Credit System.

Despite the recapitalization, losses continued in the FCS through the 1930s until the increase in demand for agricultural products caused by World War II led to a recovery of the farm sector. Higher levels of farm income allowed farmers to begin repaying their loans and stabilized land values. In the post World War II era the loan volume of the FCS expanded slowly, as did the total credit demand by U.S. agriculture. Periods of chronic surplus limited the growth of farm income, but government support for agriculture protected the financial position of most farmers. During the 1950s and 1960s the adoption of new technology resulted in two major changes in farming. The first was a major decline in the number of farms and the second was the adoption of new production methods that substituted machinery for labor in virtually all phases of agriculture. Both of these changes had the effect of increasing the demand for credit.

By 1971, the nature of credit needs and the structure of agriculture had evolved to a point that changes in the Farm Credit System were needed to improve credit availability for farmers and rural areas in general. The 1971 Farm Credit Act allowed Land Banks to lend up to 85 percent of appraised market value, rather than 65 percent of normal agricultural value, on real estate. Initially in most areas of the country the change from agricultural value to market value was of limited effect since there were no alternative uses for farmland that earned a higher rate of return than farming, and consequently the use value in agriculture set the market value. In addition, the average loan to value ratio for the FCS remained well below the 85 percent ceiling. However, over time as market values began to reflect expectations of continuous increases in the price of farmland, the changes in the Act exposed the FCS to greater risk.

By the end of the 1970s there was growing concern over the declining liquidity of farmers' financial position and their susceptibility to a drop in cash flow, or an increase in interest rates. However, in general the concern did not extend to underlying asset values. Analysts recognized that there might be an income statement problem in agriculture, but few made a link from the income statement to the balance sheet.

The 1980s farm crisis precipitated a second period of sustained losses for the FCS, which in turn led once again to federal intervention to stabilize the System's financial condition. Most analysts believe that the farm crisis of the 1980s has no single cause, but reflects the compound effects of a number of events and decisions, some of which took place within the farm sector, and others outside it.

If any one factor was a trigger for the contraction it was the rapid tightening of monetary policy in the late 1970s that had the effect of reducing farm income and raising costs. The agricultural boom of the 1970s came to an end in the 1980s, as interest rates rose, export demand declined, operating expenses grew, foreign competition increased, the global economy went into a major recession, and the exchange value of the dollar increased.

As the farm crisis deepened, its effects on lenders began to be felt. Initially, the focus of concern was on suppliers of short term credit, PCAs and commercial banks, as a growing number of farmers were unable to meet short term repayment obligations. As time passed and conditions worsened, real estate lenders also felt an increase in non-performing loans. For a number of reasons the FCS was somewhat slower than other lenders to notice the effect. However, its sole dependence on agriculture and its leading market share ensured that it would experience the largest impact.

While the Farm Credit System experienced large losses in a total volume sense, and as a percent of capital, of the commercial lenders its losses over the 1984-1989 period were less than those experienced by commercial banks. In addition, its percentage of non-performing loans was not greatly different than the competition. Since the FCS differed from other lenders to agriculture in terms of being a specialized lender, it is not surprising that its overall financial condition proved to be more susceptible to the decline in agriculture.

Recent Changes In The Farm Credit System

The structure of the Farm Credit System has changed greatly in the 1987-1997 period and it is unlikely that the period of change is over (Lee and Irwin, pp 7-15). So far four waves of changes have occurred:

- consolidation of associations in the early 1980s in order to spread capital to associations where it was needed,
- separation of the Banks for Cooperatives from the farm lending operations and
- merging of farm lending associations into ACAs as a result of the 1987 Act, (although there are still fewer ACAs than PCAs and LBAs the ACAs tend to be larger), and,
- an initial round of bank mergers between 1990 and 1995 that reduced the number of banks to eight.

The current organization has reduced the number of entities within the System from 37 banks and more than 1000 associations in 1981, to 8 banks and 232 associations in 1995. This simple accounting misses the important fact that in the process of consolidation the nature of the FCS has been fundamentally changed and it is likely that further consolidation will take place.

Prior to 1987 the System was structured with distinct geographic service areas and a single organizational form. The 12 districts had three banks and two distinct types of organization, all of which served a specific function. This structure virtually eliminated the possibility of direct competition among System entities and provided a hierarchical framework that facilitated cooperation among the districts. The fact that cooperation even under these circumstances was difficult to achieve is perhaps significant.

While in principle the ownership by farmers of the associations and the ownership by associations of banks suggests an “upside down” pyramid , the usual “narrow end up” pyramid more closely describes the old organizational structure. Bank presidents dominated the policy direction, and having a mix of different types of banks organized by geographic region made it difficult for any single individual or component to gain clear dominance.

The Agricultural Credit Act of 1987 formally introduced the opportunity for competition among System entities and we are now seeing the consequences of that change. As a result of mergers to date, there are now overlapping service areas in parts of the old Louisville, Sacramento and Spokane districts, and the former Jackson district has been split along association lines among two districts. There are arguments why competition among cooperatives providing the same service is undesirable (Barry and Brake; Rhodes) and they would certainly seem to hold when the cooperatives are linked through their debt obligations in as strong a manner as the members of the FCS are.

At the most simple level competition can unleash pressures to drive costs down or it can lead to efforts to differentiate products. The first round of mergers through the early 1990s were driven by cost considerations. Creating a larger unit was seen as an obvious way to spread overhead costs and make the FCS more competitive with commercial banks. The logic of this model leads to the conclusion that consolidation should proceed in a direction that results in large associations and a single bank.

However, firms can respond to competition by trying to differentiate themselves and capture customer loyalty. This now seems to be the direction that parts of the System are proceeding. Despite the obvious perils of internal competition, it may be the case that competition will provide a mechanism that allows the FCS to complete a reorganization process that will make it a more effective lender. The next round of mergers are likely to break the pattern where either an entire district or the vast majority of a district moves to a new bank. Instead, we will likely see further fragmentation of the geographic boundaries that have historically limited competition as associations try to find partners who share a similar management philosophy or vision for the future.

Changes in Agriculture and Finance

Through the 1980s and 1990s while some aspects of the evolutionary change in agriculture accelerated, others slowed or reversed in response to the altered environment. The decline in farm numbers slowed from rates seen in earlier times, despite the financial crisis. Concentration in agriculture continued, as the share of production produced by the largest farms increased. A bi-modal agricultural structure became an accepted description of U.S. farming.

Large, specialized family-owned enterprises, dependent on large amounts of capital, characterized one segment of farming, while smaller enterprises, making use of limited capital inputs and dependent on a mix of agricultural production and off-farm income, characterized the other main part of the distribution. Mid-sized diversified enterprises, that relied primarily on farm income, and that had constituted the core group of producers in earlier times, continued to decline in numbers. There is little to suggest a reversal of this adjustment.

However, a series of changes in the environment facing agriculture that began in the 1980s and that will evolve in the next decade are likely to affect the shape of the distribution of farms. Perhaps the biggest differences facing agriculture at the end of the 1990s from the start of the 1980s are its greater exposure to risk, and the lower level of protection from that risk provided by farm programs. By the turn of the century the last vestiges of the commodity support programs that provided price floors for much of agriculture will expire leaving farmers to manage this risk on their own.

The System's competition is also changing. The financial services industry is undergoing fundamental changes that started in the 1980s due to deregulation, financial product innovation and competition from foreign banks and non-bank

domestic corporations (Pierce; The Economist). In general these trends serve to lower the costs of raising funds for competitors of the FCS, further depreciating the value of GSE status. While the banking industry experienced a period of turmoil in the early 1990s brought on by the combination of recession and falling commercial property values it has since recovered.

Commercial banks are consolidating, numbers are down nearly one-fifth since 1980 and the trend is accelerating (Boyd and Graham). Restrictions on bank activities have been reduced allowing them to offer a broader range of financial services. However there is a concern that one consequence of these changes has been a reduced interest by banks in lending to agriculture because they have what appear to be better alternatives. Nonfinancial institutions, like farm machinery manufacturers and other input suppliers, have long offered credit to farmers in competition with banks and the System. Now purchasers of farm products such as grain dealers are also extending production credit (Duncan and Taylor). These nonfinancial intermediary sources of funds are seen as potentially major competitors for both banks and the FCS because they operate without regulation and have a more flexible cost structure.

Banks are already using financial products unheard of less than a decade ago to reduce their cost of funds. Innovative financial derivatives, such as securitization, interest rate and commodity swaps, futures and options, could further reduce the costs of the System's competition. Add operating innovations to this mix and banks may be able to force their costs of making a loan down significantly (Rhoades and Savage).

Foreign banks are also playing a more active role in lending to U.S. agriculture. Differing regulatory requirements and cheap sources of funds in foreign countries can also give these institutions advantages in competing with the Farm Credit System. for the biggest and best farm borrowers. This is particularly important for lending to agricultural cooperatives. Many of these large cooperatives are attractive customers for large European cooperative agricultural banks like Rabobank and Credit Agricole, which have parallel experience to the FCS in this type of lending.

While banks and non-traditional lenders clearly have the potential to be effective competitors with the FCS the critical question is under what circumstances they will choose to do so. As risk in agriculture increases these firms will assess the opportunity cost of agricultural lending. When conditions appear more favorable elsewhere they will reduce the flow of funds to farmers, which could have a significant impact on production and asset values, particularly if a back-stop source of credit is not available.

The Rationale For Government Intervention

Past interventions in credit markets served three functions. The first was the direct provision of funds in cases where private sources were unavailable – inadequate supply, which is the most obvious form of market failure. The second was a

demonstration effect, or information failure, to show the private sector that credit could be provided without major losses occurring. The third was a compensation effect, to offset the adverse consequences on rural areas of other policies. A relevant empirical question today is whether significant imperfections continue to exist in rural credit markets, and if so to what extent do they resemble those of the past.

Greater liberalization of banking regulations, accompanied by a host of new technologies in financial markets, has weakened the case for the existence of gross capital market imperfections (Duncan and Taylor). As a result, we no longer observe significant interest rate differentials between different regions of the country and funds flow from rural areas to urban. Thus, the most obvious argument for intervention is no longer relevant. But more sophisticated arguments for market failure exist. Three arguments are outlined.

Inadequate Supply of Funds

In 1976, Holland extended Myrdal's cumulative causation model by arguing that significant capital market biases exist that tend to perpetuate regional differentials in growth rates. Capital is biased to remaining in faster growing areas, because there are higher search and evaluation costs in slow growth areas, and there is also a perception of higher credit risk outside areas with current high rates of growth. Variations of Holland's argument are still current (Healey and Ilbury, p.63; Rosenfeld, p.135–137; Hill and Shelley, p.25–26).

However, even at a more conceptual level the question of the adequacy of the performance of capital markets is unclear. Simply observing an outward flow of funds is not sufficient evidence to conclude that all the capital needs of an area have been met. Observations of capital outflows from rural to urban areas are consistent with either a postulate of an efficient capital market, or with a postulate of a market that is biased in favor of areas that already exhibit growth. This is clearly a case where the facts are consistent with more than one theory.

Further, the existence of an apparently competitive capital market at the national level may not result in efficient credit allocation at the regional or local level. Bator's arguments about market failure still remain relevant in terms of the effects of failure by structure in thin markets (p.520), failure by enforcement due to inadequate institutions (p.521) and the impact of public good effects on pure market outcomes (p.536–537); as do the broad policy restrictions that flow from the second-best results of Lipsey and Lancaster.

Demonstration Effect

There appears to be considerable agreement that small financial institutions continue to face difficulty in making loans that are not for purposes that are common in their area (see Holland's argument noted above). While formal barriers to the movement of capital have been reduced, transactions costs, imperfect knowledge, inertia and other real world phenomena continue to have an impact on credit availability, so the

demonstration argument may still be valid. Federal programs can provide a demonstration effect either by making loans for non-traditional purposes or by providing support to existing lenders in the form of training and information on how to assess different types of loan requests.

Rural areas that are trying to diversify their economic base by adding new types of business can face significant difficulty if lenders are not willing to finance these activities. If a lender is unable or unwilling to evaluate a loan applicant because they do not fit usual criteria, it may lead to a belief that there is a shortage of good loan applicants.

Compensation Effect

Efforts to reduce federal outlays will make existing transfer payments to rural and other areas subject to reduction or elimination. Current transfer payments reflect the fact that living conditions of the recipients in these areas are below desired levels. If these payments are reduced or eliminated, then increases in the level of earned income and employment will be required to make up for the lost transfers. For this to happen investments in business expansion must take place, but without improved access to capital such economic development investments are unlikely.

For this reason it may be desirable to provide additional sources of funds for business development in those areas that will experience the greatest loss from reductions in transfers. If people are expected to rely on their own initiative, the government may be able to define a role in supporting local efforts to expand the economy. Thus an argument for targeted credit intervention may be to offset the adverse consequences in specific areas where changes in more general policies have particularly adverse consequences.

Broader Perspectives

Although substantial market imperfections have traditionally been the source of justification for past credit policy, there is a growing willingness to look beyond pure market efficiency criteria for rationales for government intervention. From this perspective an efficient capital market may produce a socially undesirable outcome. In essence this is an argument that doing something well that should not be done in the first place is not a desirable situation. To a considerable extent this perspective is rooted in notions of social equity and regional balance. Because rural people express an interest in remaining in rural areas, and there is urban support for having a rural populace, it may be desirable to alter prices to facilitate this happening.

Rationalizing intervention in financial markets now that market imperfections are less obvious is a harder task than in earlier times, but it continues to rest upon the same set of principles. The difficulty comes from the less apparent nature of market failure and a broader acceptance of market outcomes as being inherently desirable. From a public policy perspective there is great difficulty in assessing the desirability of credit market interventions, especially once non-market considerations are introduced. Existing lenders will clearly be opposed to the introduction of

additional "subsidized" competition, while potential borrowers can be expected to support such a proposal. The critical policy question becomes one of determining the public interest. In this particular part of the debate the economists' box of tools provides little help. Where economic analysis is useful is in setting out a basic structure for examining more subtle forms of market failure.

In addition, the definition of capital market efficiency is highly circumscribed. It is based solely upon information that is available at that point in time, making it a static concept. New information leads to a new efficient outcome, and looking back one can see that actions that may have appeared efficient at the time are not efficient in a dynamic sense. This suggests that more than current market signals may have a role in shaping public policy, since public policy has both a longer time horizon and broader concerns than the market provides.

Has The FCS Exhausted Its Mandate?

In the past the federal government has played a significant role in financing economic development in the United States. As the nature of development and the nature of capital markets have changed, the role of the government in credit markets has also evolved. Direct provision of credit was a standard approach in earlier years, but now government typically chooses to operate through existing intermediaries or facilitate the development of new financial instruments or institutions. This reflects the increasing sophistication of credit markets. And as the nature of markets evolve, it is reasonable to question whether past policies remain appropriate.

Although it is far harder to demonstrate credit market imperfections today than it was sixty years ago, there is still a case for the ongoing existence of market failure that is rooted in information failure and off-setting externality effects. In rural areas the impact of these types of failure may well be exacerbated, because of the thinness and isolation of rural markets. In this situation the problem may be a shortage of intermediaries more than a shortage of funds. This suggests that government credit programs may play a more significant role than in urban areas. Even though the market appears efficient at present, a small change in the number of lenders could have major consequences.

Of the GSE's, the Farm Credit System is unique because of its cooperative organization and because of its rural focus. Clearly much of its initial task has been accomplished - commercial agriculture now has access to adequate credit flows. Yet credit for other parts of rural America remain in limited supply (GAO; RUPRI Rural Finance Task Force). If one broadly interprets the original mandate of the FCS as enhancing rural economic development by helping farmers it is clear that additional work remains, but if a more narrow interpretation is applied of just helping agriculture rather than rural America, it is possible to conclude the objective has been met.

Maintenance of public support for the FCS in the form of agency status and a Congressional charter, requires that it continue to serve a public role. Certainly conditions in agriculture and rural capital markets have changed greatly from the time of the creation of the FCS in the early part of the century and during the great depression. One must ask whether the changes are such that the FCS is still needed to ensure an appropriate flow of capital to agriculture?

Through the decades the number of farmers and the importance of primary agriculture to the national economy have declined. Farmers now account for less than 2 percent of the population, and the majority of those counted as farmers produce a minuscule fraction of agricultural output. Primary agriculture itself now accounts for less than 3 percent of GDP. Fewer than 20 percent of rural counties were farm dependent in 1986 as compared to over two-thirds in 1950 (Collins). In a national context, ensuring the provision of credit to agriculture is less of a priority than when the FCS was founded.

More importantly, the decline in farm numbers has major implications for the System. As farm numbers decline there are fewer borrowers to serve, which raises FCS operating costs on a per borrower basis. An additional factor strengthens this point. American agriculture is experiencing a structural shift with the major decline in farm numbers coming from mid-size producers.

Mid-size farms have traditionally been the primary market for the System. Large farms are able to tap regional or national credit markets for their financial capital and are therefore less dependent on the existence of the Farm Credit System. Farms with a small value of gross receipts tend to arrange their credit needs on the basis of off-farm income and wealth. Therefore both ends of the farm-size spectrum are less dependent on the Farm Credit System as a source of funds.

While different FCS districts have different distributions of farm sizes and consequently emphasize different lending strategies, each district faces the problem of an eroding loan base. In each district either the number of eligible borrowers is shrinking, particularly for mid-size farms, or competition with other lenders for high-quality loans is strong. In the short run increases in the market share of farm loans may allow an association to build loan volume, but there are limits to this type of expansion. And in some cases associations have already captured the vast majority of their traditional market.

Equally important, the decline in farm numbers is concentrated in the group that is most likely to meet the historical rationale for agency status for the System. For both large and small farms it is harder to develop a case for the continued need for an institution with agency status to provide agricultural credit. Mid-size farms that are restricted to local credit markets, and must borrow solely on the strength of their agricultural income are those most likely to continue to experience the types of credit gaps that were the trigger for the creation of the Farm Credit System. So their decline in numbers inevitably affects the future of the FCS.

USDA analysis of the distribution of farm income by household makes this point clearly (Perry and Hoppe). Of the 2.1 million farms in the country only 400,000 have sales of more than \$50,000 and have an operator who considers farming as his or her primary occupation. The other 1,700,000 farms rely primarily on off-farm income for household maintenance. While each of these groups has an aggregate household income that is comparable to the national average, the 1.7 million other than full-time farms have an average annual farm loss of \$614. The figures suggest that net farm income would actually increase if these people were not in the sector, which makes it harder to rationalize a government interest in using the FCS to support part-time farming.

Conclusion

There is clearly a case for concluding that the Farm Credit System has achieved its intended purpose and no longer deserves GSE status. For the last ten years there has been little evidence of credit shortfalls for commercial agriculture and commercial lenders appear capable of providing for all the credit needs of agriculture, particularly if the development of lending functions by non-traditional sources of credit is considered. In addition the relative wealth of farmers compared to other segments of society would suggest that equity considerations may be better served by applying scarce government resources elsewhere.

While this is an appealing argument there are some remaining doubts about both the nature of the mandate of the FCS and the degree of perfection of rural credit markets that make accepting withdrawal of GSE status more difficult. The first is a question of focus of the FCS. While agriculture may have adequate capital, it is less clear that rural business is as well served. Because the FCS has proved itself to be an effective way to enhance credit flows to one sector in rural America it may be worth considering redirecting the System so that it has a broader mandate of providing small business credit to all forms of rural business. Such a strategy would make use of the credit skills of the FCS, since farming is just a form of small business, and it could also help address the twin concerns for the FCS of a declining demand for credit in agriculture and the risk associated with being a single sector lender.

Further, there may be reason to doubt the long term reliability of some of the current sources of agricultural credit. Rural credit markets are by definition thin and consolidation of the commercial banking sector is making them thinner. While it is possible that the new sources of credit may be enough to provide workable competition, we have not seen how well these new sources of finance perform in a less favorable farm income environment. Certainly we know that farm income must fall at some time and that there are now none of the traditional supports in place to limit that fall.

The strength of the FCS has been its commitment to agriculture that comes from its restricted charter and cooperative structure (Barry, p 85-87). However these features are also what make continuation of GSE status necessary. Anything beyond a cursory examination of rural financial markets suggests that the conditions for a competitive market do not exist, so it is conceivable that removing the FCS as a competitive yardstick could induce major changes. If society wants to maintain a credit backstop for agriculture it is difficult to see how GSE status can be removed.

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Figure 1: Rural, Farm and Urban Population

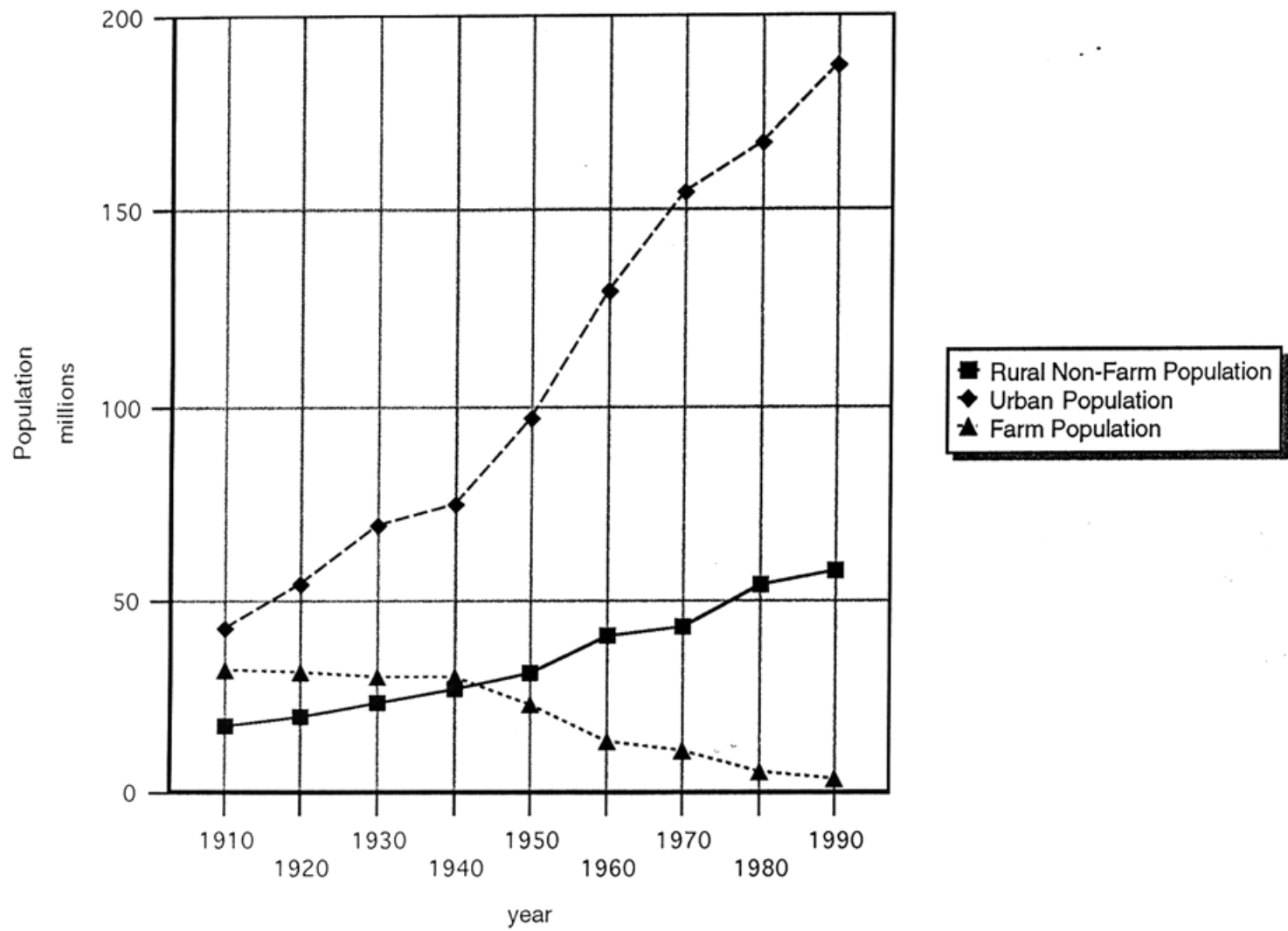


FIGURE 2: LENDER SHARE OF FARM DEBT

