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Vol. 24 No. 1  
APRIL 1985

Price 50c  
(45c + 5c GST)

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BIENNIAL JOURNAL  
ON AGRICULTURAL  
ECONOMICS

Issued by the Department of Agricultural Economics and Marketing



# STRATEGIC PLANNING AND ADAPTATIONS: FINANCING\*

by A.S. JACOBS\*\*

Because of the special requirements of and risks attached to the financing of agriculture, the Land and Agricultural Bank of South Africa was established as long ago as 1912 to provide for the special financing needs of agriculture. A further development which also had important implications for the financing of agriculture was the creation of the system of control boards and co-operatives in the 1930's. The financing of agriculture by the Land Bank through the agricultural co-operatives, for which purpose funds are obtained largely from the banking sector through the issue of credit instruments which qualify as liquid assets in terms of the Banking Act, today still plays an extremely important role - particularly in respect of the provision of short-term credit.

Recognition should nonetheless also be given to the fact that apart from the funding of the Land Bank, the banks are also important providers of credit direct to producers, particularly in respect of short and medium-term credit. Although medium-term credit for the purchase of agricultural implements, among other things, can be obtained from the Land Bank, producers often choose, particularly because of the requirements for such loans and the conditions under which they are granted, to make use of the more expensive bank credit. The point of view of agriculture is that the banking system is not ideally suited to meeting its special financing requirements and that the Land Bank should be developed to a greater extent for this purpose. What is actually meant by this is that the conditions under which the banks provide producers with credit are often unacceptable to them.

The total loans and advances by the Land Bank to agriculture increased from R902 million at the end of 1972 to R4 567 million at the end of 1982 - i.e. an increase of 407 per cent over a period of 10 years. Although the South African economy also grew considerably during this period, the rate of increase in the Land Bank's provision of credit nonetheless indicates the increasing demands which agriculture is making on the country's sources of finance and the effectiveness of monetary policy.

Apart from the fact that the Land Bank accepts deposits from the agricultural co-operatives and control boards, the banking system is its most important source of funds. At the end of December 1982 the Land Bank's deposit obligations amounted to R608 million, of which R371 million was on call and an amount of R3 609 million had been obtained

from the banking sector in the form of advances, the discounting of Land Bank bills and investment in Land Bank bonds. All these assets count as liquid assets of the banks which increase their capacity to advance credit and thereby hamper the application of effective monetary policy and therefore the combating of inflation.

Apart from the Land Bank's financing of agriculture, the banks also supply credit direct to agriculture. Such credit provided increased from R336 million at the end of 1971 to R1 697 million at the end of 1981, representing a rise of 405 per cent, and R1 904 million at the end of June 1982. Apart from credit for financing their domestic expenditure, producers were also dependent on banking institutions for the financing of certain farming expenditure (such as wages) and they also used mainly hire purchase and leasing facilities at banks for the purchase of tractors and farming implements - in which case the conditions under which these facilities were made available are of cardinal importance.

## INFLATION

In the nature of things the inflationary conditions in the Republic have important consequences for the financial markets, the demand for credit and particularly interest rates. A high rate of inflation implies high nominal interest rates and not the reverse as producers so often wish. The agricultural community usually contends that it is in the national interest that it should have unfettered access to sufficient and cheap credit facilities in order to be able to produce cheap food. Such a policy naturally influences not only the optimum allocation of resources (seen purely from an economic point of view), but can also restrict the effectiveness of the monetary authorities' credit control measures - and thereby contribute to sustained inflationary conditions.

Inflation can lead to a decline in farm income, the appreciation of capital assets in agriculture, a decline in producers' liquidity and greater instability in income. If a period of high inflation coincides with a downward phase in the business cycle and serious drought conditions in agriculture with accompanying losses in income, it follows that the producers' debt burden will increase and they will be exceptionally susceptible to the interest rate on their rising burden of debt.

However, the fact remains that inflation and inflationary expectations also exert an important influence on the spending and investment decisions

\*Paper read at the 21st annual congress of the Agricultural Economic Association of South Africa at Pretoria, April 1983

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of producers. They would like to borrow cheaply, but invest their savings as advantageously as possible. It is an open question whether the policy of cheap loans (also in respect of housing) is always in the longterm national interest. The result of this is that the value of the assets concerned (land and houses) rises more rapidly, which means that the financial burden and interest payments of successive purchasers become larger, so that they have to carry the burden of the inflationary process. Low interest rates for agriculture therefore stimulate the demand for land and encourage excessive investment in tractors and farm implements.

### **THE FARMERS' BURDEN OF DEBT**

The total agricultural burden of debt rose from R1 465 million at the end of 1971 to R4 883 million at the end of 1981 and the total investment in agriculture from R10 199 million to R29 944 million over the same period. This indicates that the debt ratio of agriculture did not increase much over the period concerned, namely only from 14,4 per cent to 16,3 per cent. The conclusion may therefore be drawn that producers maintained their credit-worthiness to a large extent, although this information throws no light on their cash flow. The present tendency of financial institutions is to judge the risk and credit-worthiness of producers more on the basis of cash-flow analyses than on the asset-debt ratio.

If agriculture's burden of debt is deflated by the producers' price index, it does not show any significant increase for the decade ended 31 December 1981. It declined from R1 422 million at the end of 1971 to a low point of R1 047 million at the end of 1974 and thereafter rose again to R1 309 million at the end of 1981. From 1976 to 1981 the net farm income of producers rose by 144 per cent, against the 112 per cent of their total debt burden. According to this norm, the producers' credit-worthiness also remained exceptionally good, although the drought damage experienced in the summer rainfall areas in the past two seasons naturally altered the situation radically.

It therefore cannot be categorically claimed that the rising burden of debt of agriculture is a reflection of its economic retrogression. The greater part of this burden of debt was voluntarily taken on by producers in order to farm more efficiently and intensively. In times like the present, when serious drought conditions prevail, the "enforced" component of this burden of debt will naturally rise.

Another important characteristic of the producers' total burden of debt, is its increasing short-term portion. Whereas only 27,3 per cent of this burden of debt at the end of 1971 was of a short-term nature, this relationship rose to 45,6 per cent at the end of 1981. This phenomenon is partly attributable to the fact that long-term loans were more difficult to come by for agriculture from insurers, pension funds and banking institutions. Alternatively it indicates incorrect financing techniques on the part of producers. In the new

financial dispensation now developing, interest rates on the producers' short-term burden of debt will be subject to greater fluctuations than in the past. The financial consequences for producers who, among other things, have purchased land with the aid of short-term credit from banks, can therefore be serious if interest rates were to rise sharply - as indeed was the case in 1982.

### **FREER FINANCIAL MARKETS AND THEIR IMPLICATIONS FOR THE FINANCING OF AGRICULTURE**

Competitive markets that react to market-oriented monetary and fiscal measures are needed in South Africa's battle against inflation and for the effective control of total domestic expenditure, the protection of the external value of the rand and the promotion of economic growth over the long term.

Some economists hold the view that certain structural elements are responsible for the sustained high rate of inflation in South Africa and that the removal of factors which influence free competition will of itself cause the inflation rate to drop. The implication is that monetary and fiscal control measures do not have an important role to play in the struggle against inflation, provided that a country has free and competing markets. Although free and competing markets are important to any country's struggle against inflation, they do not eliminate the need to follow a policy of financial discipline as well. Free and competing markets are needed precisely in order to combat inflation more successfully through monetary and fiscal measures.

Not only in South Africa, but also in Australia, Britain and the United States of America, there has been a move over the past two years towards the creation of freer and more competitive financial markets, through which market-orientated, instead of direct, policy instruments can be applied to achieve the national objectives. This policy approach also holds important implications for the financing of agriculture, of which we have already begun to see the effects in the past year or two. The investigation of the De Kock Commission into South Africa's financial markets and its recommendations for their reform as a prerequisite for the implementation of a more effective monetary and fiscal policy have not yet been completed, but the authorities have in the meantime already started moving towards the implementation of more market-orientated policy measures. This holds good not only for agricultural financing via the Land Bank, but, *inter alia*, also for the financing of housing via the building societies and the loan issues of the public sector.

### **THE FUNDING OF THE LAND BANK**

The practice whereby the Reserve Bank provided part of the Land Bank's funds with which short-term credit was supplied to the agricultural co-operatives has already been phased out during the past couple of years. This meant that apart from its

deposits, the Land Bank has used overdraft facilities at the commercial banks to acquire funds with which short-term credit was supplied to the agricultural co-operatives - besides the Land Bank bonds issued for providing, among other things, medium and long-term loans to producers, co-operatives and control boards.

Although the change in the Land Bank's source of financing from the Reserve bank to the commercial banks was already a positive step in reducing the inflationary financing of agriculture, the commercial banks' advances to the Land Bank at favourable interest rates nonetheless qualified as liquid assets, increasing the banks' credit-creating capacity.

For the commercial banks the Land Bank's increasing need for financing created the problem that, with the higher cost of deposits, their "interest subsidy" to agriculture in terms of the existing arrangements increased steadily. At the end of March 1982 the commercial banks' advances to the Land Bank totalled no less than R2 307 million. The banks' standpoint was that it was not their task to "subsidise" agriculture through the Land Bank by means of cheap loan facilities and moreover that they could not negotiate the advances in the financial markets. Their request was consequently that their provision of credit to the Land Bank should take place at market-related interest rates and that this financing should take place largely through the issue of negotiable credit instruments. Such papers can be sold to other banks and institutions outside the banking sector and even used for accommodation purposes with the Reserve Bank, if need be by means of the discount houses.

Following on this, the Land Bank, in arranging its financing facilities with the commercial banks for the year ending 30 June 1983, converted a portion of its existing overdraft facilities to Land Bank bonds of one, two or three years and a further portion into Land Bank bills with a currency of three months. The overdraft facilities are limited to R500 million and as the Land Bank draws on these facilities with the commercial banks, the advances are converted into Land Bank bills. This means that there is thus an attempt to fund the Land Bank in such a way that its lending rates can be adjusted reasonably easily upwards and downwards in the wake of interest rates in general.

The second objective in the funding of the Land Bank and the financing of agriculture was achieved in this manner. However, the third aspect, which in the nature of things will be more difficult, still lies ahead. Although the Land Bank at present finances agriculture without using credit from the Reserve Bank and obtains its funds from the commercial banks largely through the issue of negotiable papers at interest rates which can be regarded as reasonably market related, it should be borne in mind that this method of funding the Land Bank allows the liquid assets of the commercial banks, and consequently their capacity for supplying credit, to increase continuously. This is indicated, *inter alia*, by the fact that the Land Bank's

short-term financing requirements for the current year are estimated at R3 100 million.

The general expectation is that the De Kock Commission will recommend that the banks' existing liquid asset requirements be considerably reduced and that the liquid asset system of credit control be replaced with a cash reserve system. This will mean that the "captive market" for liquid assets will be considerably smaller in the future, with the further implication that the interest rates on the competing credit instruments which qualify as liquid assets will also have to be more market related. For this reason it might also be necessary to let the spotlight fall critically upon the assets which in terms of the Banking Act still qualify as liquid assets and the type of transactions which are financed with them.

The most important characteristic of a liquid asset is usually that it finances the movement of goods and is therefore self-liquidating. In this respect the financing of agricultural co-operatives' purchases of agricultural products and stocks of agricultural inputs, etc., by way of cash credit advances obtained from the Land Bank, for which the necessary funds would be supplied through the issue of Land Bank bills qualifying as liquid assets in terms of the Banking Act, would be acceptable. The same would not, however, be valid for the Land Bank's production credit loans to co-operatives, nor for the Land Bank bills which are marketed for the granting of medium-term loans (for the purchase of implements by producers) and long-term loans to producers. According to accepted banking principles and to promote a more effective monetary policy, it would therefore be desirable that this type of transaction, which the Land Bank finances through Land Bank bills and overdraft facilities as liquid assets, be limited basically to agricultural and input stocks, including agricultural machinery held for sale. If this step were to be taken, drastic changes would take place in the financing of agriculture in the coming decade.

## CONCLUSION

The funding of the Land Bank led to an increase in the commercial banks' holdings of liquid assets from R551 million at the end of 1972 to R3 609 million at the end of 1982. The commercial banks' total credit advances to the Land Bank amounted to some 55 per cent of their total liquid asset holdings at the end of 1982. If the Land Bank's need for financing by the banks were to increase at the same rate in the next decade as in the past one, this would bring their liquid asset holdings at the end of 1992 to R23 640 million. Even for a growing economy, this sum appears unacceptably large - its implications for monetary policy purposes aside.

My deduction is therefore that the banking system will probably play a greater role in the future in the direct financing of agriculture at market-related interest rates. However, this does not necessarily mean that the existing financing pattern of commercial bank-Land Bank-agricultural co-operative will be changed drastically. From an

administrative and risk point of view some banks find the present financing system advantageous, even were their supply of credit to the Land Bank for the financing of producers no longer to qualify as a liquid asset. In this respect it should be borne in mind that even if the Land Bank were not to obtain its funds through the issue of liquid assets for the supply of production credit to producers via their agricultural co-operatives, this channel of financing would still be the cheapest form of financing for the producers, because most cannot themselves acquire credit from the commercial banks at the prime lending rate. In times of poor harvests, when the producers' burden of debt and interest rises sharply, the State will have to consider subsidising the producers' interest rates.

In the changing agricultural financing system, heavy demands will be made on producers' financial management. In this respect the advice of the co-operatives will be indispensable. The co-operatives will likewise have to take steps to increase their sources of internal financing. From the purely institutional point of view no drastic changes to the agricultural financing system are therefore foreseen for the next decade and it can be accepted that the Agricultural Credit Board will continue to act as the producers' credit supplier of last resort and carry out special financing functions from an agricultural policy point of view.