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RECENT TRENDS AFFECTING FARM AND RURAL BUSINESS FINANCE

by

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The availability and cost of capital are important factors affecting the viability and vitality of any sector of the economy. The relationship between the performance of the capital markets and the health of the local economy is especially important in rural markets which have historically lagged metropolitan areas both in time, and in the sophistication of capital products. Additionally, rural financial markets are more dispersed than their urban or metropolitan counterparts, and commonly used measures of concentration generally indicate less competitive rural lending markets, even though the evidence on cost and availability of debt capital is mixed at best. On the regulatory and policy front, there is a renewed emphasis in rural economic development programs, and yet many believe that rural capital markets are insufficient to fully facilitate the broad scale economic transformations they envision. At the same time, liberalized bank branching laws and the continued consolidation of the banking sector raise concerns about potential detrimental impacts on local economies – although again the evidence to date is mixed at best. Federal budget pressures continue to limit the scope of direct involvement in traditional assistance programs in favor of indirect and guarantee programs. In any case, it is generally agreed that the rural financial sector is undergoing dramatic changes, and that the health of the markets it serves depends importantly on its ability to meet the challenges of the future. Thus, my charge today is to identify some of the more important trends affecting rural financial markets and the businesses they serve. Given the *Outlook* theme of the conference, I will try to distill some of the causes and consequences, and occasionally venture cautiously into predictions about how they may play out in the future.

But, before moving to the future, it is worth benchmarking today's situation in general terms. Of course, any generalization will miss cases on both sides of the standard, but according to many measures, the status of the rural economy is reasonably good. Figure 1, which shows the price history of U.S. farmland from 1960 to 1997, summarizes the status of the rural economy over the same period. After the sharp run up in prices through the 1970s, the ensuing decline through most of the 1980s accompanied a generally depressed agricultural economy. Then, late in the 1980s, the recovery began and farmland values and the state of the rural economy in general, rebounded to levels today that by historic trends appear quite good. Farmland is used to illustrate the general trend both because of its importance (representing approximately 75% of ag asset values), and because it mirrored accurately the health of the rural economy.

Fig.1 U.S. Farmland - Price History

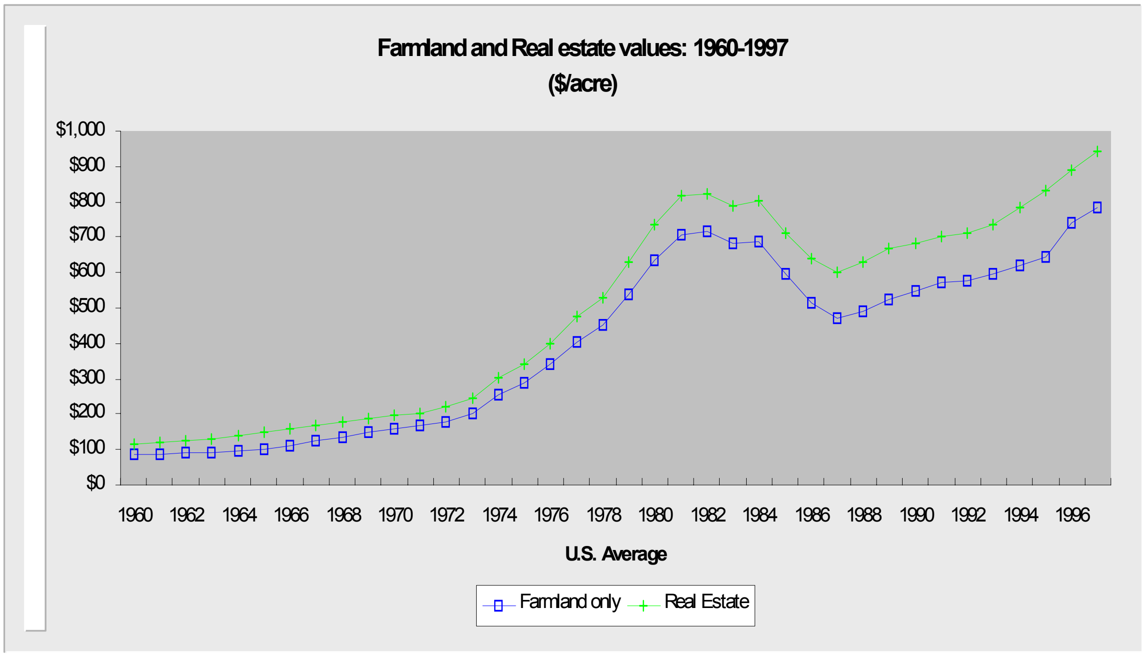

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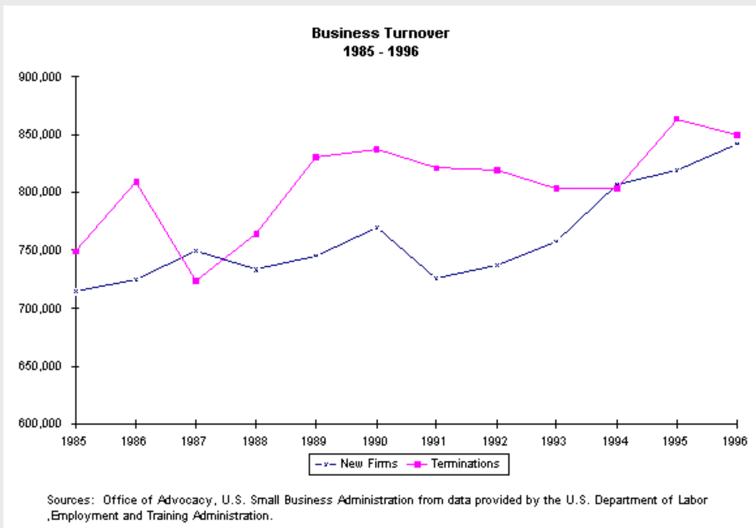
Figure 2, showing small business formations and terminations provides some corroborating evidence although the gap was delayed past the lowpoint for the farmland market. Data for rural areas alone are not readily available, but the small business component of the rural economy was probably not markedly different from that displayed by aggregate data. Trends and IRS business return data indicate that new formations now exceed terminations and that the “recovery” of the small business population appears to be going well.

Thus, in total it appears that since the widespread economic downturn of the mid 1980s, the rural economy has made a nearly complete recovery. Nonetheless, concerns about returning to those historic conditions serves as a caution against abandoning efforts to improve capital markets still further. What, then, are the important deficiencies of these capital markets, and what will be the future capital needs of rural America? Fortunately, much of the work to identify and answer those questions has already been begun. Time constraints prohibit my providing a complete summary, so I will first refer those interested in more information to the proceedings of a conference hosted by the Federal Reserve Bank of Kansas City entitled, *Financing Rural America*. The proceedings contain a collection of relevant studies examining competitiveness of rural markets, prospects for secondary markets, liquidity and funding issues, and other factors that will accompany the resolution of its central question about what can and should be done to maintain and improve rural capital markets. At that conference, it was also noted that the rural economic health, though historically equated with agricultural conditions, now requires a much broader definition and it is this definition that I employ throughout as well.

Regions that were historically dependent on agriculture are beginning to diversify their economic bases, and the attendant capital needs for housing, business development, public

Fig. 2 Business Formations/Terminations



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infrastructure, and the like may place new demands on rural capital markets (Drabenstott and Meeker). The point I would like to make is that the current financial capital needs of rural America are much broader than the historic set of demands derived primarily from the farming sector alone. Likewise, the set of participants in the future will be broadened from the farmers, community banks, Farm Credit system institutions and rural non-farm business owners that might have historically served as a sufficient subject for this topic.

To organize my comments, I have loosely classified each of the factors and trends that I want to discuss into four general themes. Not all the factors and trends fit neatly into precisely one of the categories and thus, the classifications are interrelated and incomplete. Nonetheless, they serve as an organizing mechanism and hopefully are not too distracting from the points contained within each. The four themes are: 1) technological trends, 2) government, regulatory, and political environments, 3) social, demographic, and institutional factors, and 4) economic, business, and competitive issues including the structure and performance of the banking sector. Within each of these, selected, but not exhaustive lists of important forces are identified, and brief exposition given about their implications for the future. There are intermixed issues of both farm and nonfarm businesses within the rural boundary, as well as factors differentially affecting supply and use of different forms of capital (largely debt and equity). After these are presented, brief conclusions are provided.

***Technological*:**

Remoteness and the "six clicks of separation"...

Though somewhat *cliche*, the much heralded information age holds the promise to radically affect – even redefine to some degree – rural economies. The "six degrees of separation" which has become a euphemism for the interconnectedness of individuals is being replaced by the "six clicks of separation". Advances in information and communications technologies have begun to redefine proximity in terms of the number of mouse clicks it takes to connect, rather than geographic distance. Drabenstott and Smith refer to "new spatial linkages" that can no longer be proxied by distance. It is this concept of "economic distance" or the difficulty in arranging transactions that could redefine rural not in terms of its distance to population centers, but in terms of the developments that facilitate transactions and information exchange. Lower costs information technologies also tend to reduce the minimum size of capital transactions since the lower, but still sunk cost of assessing a potential deal, doesn't have to be spread out across as many dollars to dilute its effect to an acceptable level.

Information as a competitive tool, a two way street...

At the same time that consumers find it increasingly simple to shop large numbers of potential vendors via internet searches and the like, providers of financial services are increasingly able to segment markets more finely due to improvements in information systems. Scanner data from grocery stores are routinely used to target consumers with personalized offers at a level of specificity that sometimes startles me by the accurate anticipation of future purchases. Can financial markets be far behind? Already there is a great deal of sharing of information between credit card providers and ancillary service providers based on the nature of the use of credit. And, improved score carding methods are being used that include more and more data fields and less and less requirements for local observable information. Thus, while information technologies reduce the economic frictions in typical financial relationships, they also lower the barriers for participation. The issue for rural financial market participants will be whether they can keep up and integrate the advantages of location with information that is no longer as confined by locale.

Payment and transaction systems...

As consumers become more comfortable with online payment and transaction systems, the location of the facilitating banking institution becomes less important. And, the costs per transaction continue to fall. To some degree, the differentiation between traditional debt providers and other financial service providers gets blurred - particularly in terms of deposits and money accounts that then appear identical on the home office computer screen. Again, as the need for a local visible physical presence diminishes, local borrowers may enjoy improved access to new financial products and services.

Separation and blurring of traditional banking functions

Improved information technologies have also permitted an increasingly finer separation of the traditional banking functions. Origination may now more easily rest with vendors or point of sale locations, funding can take place on national markets, underwriting in a specialized organization, traditional backroom service providers may carry the transactions and so on.

Likewise, regulation and oversight function should become easier as the reconnaissance can more
easily be done remotely. In my own case as an example, my university paycheck is electronically deposited in a local bank, and a monthly automatic withdraw is made of a fraction that then goes to a money market fund in a local office of a national brokerage house. That account then pays a mortgage servicer at third bank that forwards it to the pooler that purchased my mortgage from a mortgage originator that I happened to locate by an internet search of FDIC reports based on loan to deposit ratios! My reason for searching? I was not satisfied with the very first bank's rates when I refinanced my mortgage that they formerly held. The reasons for this convoluted arrangement are a series of insignificant points in my own history, but I no longer have much concept of where institutional boundaries begin and end and each of these transactions was accompanied by benefits (not costs) for association with my business. More to the point, the market barriers in rural markets are likely falling as the capacity to enter those markets is improved with information technologies.

Scale Effects

Contrary to the previous point, there are significant scale effects that on their own present disadvantages to local providers in rural markets. This effect is distinct from the issue of whether community banks have sufficient capacity to fund large scale development projects.

My sense of what this means for rural markets is a general improvement in performance, by capital providers but I am actually a bit less optimistic that it will lead to a reduction in the "gap" between rural and nonrural markets. The technological half-life, it seems to me, is still generally underappreciated and I do not expect that rural markets will suddenly begin adopting new technologies at an increasing pace relative to non rural markets.

Government, regulatory, and political:

Rural agenda replacing agricultural agenda .....

Structural changes in the agricultural sector have been followed by a natural realignment of its political influence. No longer does the "farm bill" dominate the agricultural agenda, and the agricultural agenda itself has been somewhat redefined in terms of rural issues-in-the-large. Food safety issues now occupy an important part of consumers' collective consciousness about agricultural production as do environmental impacts associated with food production. A result of this political realignment there is feeling by many rural producers that their "efficiency" at producing low cost and plentiful food now requires that additional attention be devoted to safety, environmental sensitivity, and attributes that are now part of the regulatory environment rather than assumed features of their own ethic.

Declining direct involvement toward sponsored involvement...

Government budget pressures, while ever present, have recently been credited with favoring indirect over traditional direct government support programs in housing, agriculture, rural development, and so on. The bad news is that it is increasingly unlikely that a future rural decline would be accompanied by large scale infusions of capital from the federal government. The good news is that sponsored enterprises (including secondary markets in housing, and some targeted loan guarantee programs) have provided some great success stories. And, community based private market efforts to facilitate economic development likewise are beginning to flourish.

Liberalized bank branching and authorities....

There is a mixed message to rural economies from the results of liberalized bank branching and the continuing consolidation of banks, as well as from the continued relaxation of Glass-Steagall restrictions. Traditionally, local business (farm and nonfarm) have relied on local and community sources of debt capital. As more and more community banks are purchased by regional or national parents, or consolidated into more aggregated holding companies, questions arise about the impact on local availability and pricing of credit. The empirical evidence is mixed at this point, but on balance suggests a slight destabilization of local availability and a reduction in business and agricultural lending (see Gilbert for summaries). Prospective studies likewise anticipate reduced lending to small businesses as banks are merged into larger organizations and become less dependent on local borrowers (Keeton, Berger, et al.). At the same time, affiliation with larger entities leads to improved funding and liquidity opportunities.

Agency market access for funding, liquidity – and distribution of authorities...

Perhaps the most controversial issue that will ultimately be resolved through the political process is through what mechanism, if any, will access to agency market funding be made available to rural markets and for what purposes. At the most general level, there are those who argue that the government backing on funding channeled through Farm Credit, Fannie Mae, Freddie Mac and so on is no longer needed while others argue that additional conduits to agency markets are needed to ultimately support business loans, rural infrastructure development and improvement projects and so on. The *actual* policy debate, however, is much more specific. Even accepting that the role of a GSE is to fill a gap that exists when private market benefits are less than costs, but for which the public costs are less than the benefits, the question remains as to the mechanisms for doing so. In terms of lending to rural enterprises, there are current competing proposals to expand access to Federal Home Loan Banks by relaxing collateral and membership requirements, or expand the access to Farm Credit system funding by commercial banks. The political chess match has been made three dimensional by Farmer Mac's recent revitalization and arguments for expanded authority to further develop secondary markets in rural America. Regardless of your posture toward any of these most notable players, the empirical evidence of less reliable deposit-based funding is strong (see Barry and Ellinger for a more complete development). The "deposit drain" affecting rural community banks as individuals switch more and more toward money accounts and mutual funds at brokerage firms shows no signs of reversing. Thus, the resolution of this debate will, in all likelihood, fundamentally affect the structure of the financial industry lending to rural America. Still, the proposed policies focused on access to agency market funding have been difficult resolve as much due to their competitive non-neutrality as due to questions about their economic desirability.

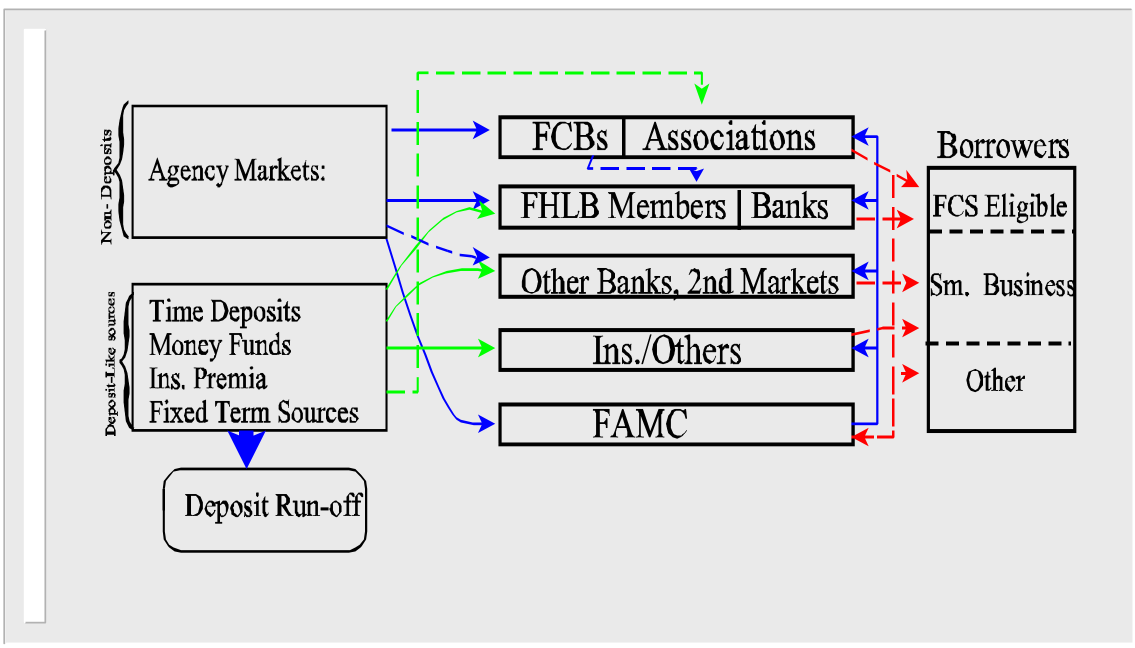
Figure 3 schematically represents some of the linkages from agency funding sources to borrowers in the agricultural sector with existing channels (lines) and proposed channels (dashed and light). Given the number and complexity of paths, it suggests that simplicity is not likely the policy imperative and that multiple channels are apparently acceptable and perhaps even desirable. Further, the inertia of the political process implies that it is unlikely that complete elimination of agency access is even remotely feasible. The real policy issue is to define how, not if, rural America will source money needed to capitalize its growth and evolution.

Social, demographic, and institutional:

Aging asset ownership of rural assets...

Although empirical support is sparse, concerns exist about the aging rural population in

Fig. 3 Agency Market Access & Channels



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terms of asset ownership. Significant questions exist about the ability to facilitate the transition in ownership of closely held enterprises (especially farms and rural family businesses) and about willingness of a new generation of owners to commit to local communities. Although this is primarily an issue of size and form of business organization rather than location *per se*, the most vulnerable population is probably more concentrated in rural areas.

Environmental awareness - responsibility shifts...

The rural community is being increasingly held responsible for society's perceptions of the status of the environment -- and not just by farmers. Historically, the government was perhaps more heavily relied upon to regulate and insure that suitable protection standards were enforced. In the future, I suspect that one of the "products" of rural America will be an "environmental condition" that is acceptable to consumers of the remainder of rural America's products. Thus, more frequently in the future, financing may be tied to a set of desired environmental attributes as a condition of the loan.

Regionalization of markets...

The livestock and dairy industries have witnessed massive shifts in the location of production units that have accompanied consolidation over the past decade. Manufacturing businesses likewise have regionalized to some degree. A seductive prospect for further rural development is sometimes posed in the possibility of attracting more manufacturing to non-metro locations although there is little empirical support for this prospect (Barkley). More likely are service industries, recreational facilities and "way of life" attractions – manufacturing requires plentiful and inexpensive labor – both rare attributes in parts of rural America.

Quality of life issues - labor, housing, health care, education...

A plethora of "quality of life" issues affect the future prospects for rural economic progress. The wish list, of course, involves a pristine accessible natural amenity with affordable high quality housing, quality health care, high quality education, low population externalities, and the like. Few locations possess each of these attributes – at least for very long! Still the point remains that development of nontraditional resources may hold the greatest promise for economic development in some rural communities rather than focusing on traditional agricultural, small businesses and light industrial firms to cause economic development.

***Economic, business and competitive issues**:*

Consolidation of banking and production sectors...

In addition to the effects of a consolidated financial services industry, (see section on government, regulatory and political environment), the agricultural production sector continues to consolidate and move to production under contracted arrangements. Local community banks often find it difficult to lend to highly integrated operations due in part to the scale of the operations and also because the nature of these operations makes underwriting more complicated and involved. In many cases, additional equity is also needed in the "deal" and traditional financiers have served mixed roles in locating the complementing capital. As this trend continues, the local producers will increasingly rely on non-local sourcing of funds.

Measures of rural financial market competitiveness and accessibility have shown that rural banks are smaller, more dispersed, and by many measures, exist in less competitive markets. However, table 1 provides some additional information that confounds the interpretation of competition a bit. As shown in the final column, bank locations per unit population unit are actually higher where populations are thinner. If one further considers the number of "partial" outlets represented by ATMs and kiosk banks in places like grocery stores, issues of location and service distance are even less clear.

Agency market access and deposit drain...

The issue of agency market access (described briefly above) will in important ways determine competitive and cooperative relationships that hold the potential to significantly affect the structure of the market. In any case, a move away from deposit-based funding of loans in rural America toward more securitized or agency funded sources is virtually insured. The result of more standardized and more securitizable loan products is largely a positive for borrowers – unless it arises solely as a result of the elimination of customized loan products. There will always be a role for the local lender to fill and increasingly, there are roles for non-local sourcing in developing rural enterprises as well.

Table 1. Bank Competition

County Types and Measures of Competition - 1995

County Type	Counties	Ave# head offices	Ave #. branches	Ave.Bank Size ($M)	Branches per 10,000 pop.
Farming(all)	291	1.6	3.5	37.1	7.58
Mining (all)	33	0.9	3.6	62.2	3.70
Mfg. (all)	49	1.4	4.7	58.8	4.27
Other (all)	158	1.5	4.4	58.7	4.29
Farming(some)	265	2.7	6.5	51.7	5.04
Mining (some)	114	2.0	7.5	95.9	3.28
Mfg. (some)	467	2.5	12.6	122.8	3.71
Other (some)	927	2.8	11.2	93.9	3.74
Small Metro	205	4.4	31.2	120.4	3.01
Other Metro	632	6.0	76.8	594.1	2.58

Source: Barry and Ellinger

Equity market developments....

For numerous reasons, equity markets have been slow to develop in agricultural assets in particular, as well as for small business needs. At the same time, aggregate equity positions in agricultural assets are extremely high in comparison to other sectors of the economy. As new, more integrated, coordinated, and larger scale production units continue to form, there will be increasing pressure to develop functioning equity markets supporting agricultural and other rural businesses. My crystal ball doesn't project an image for much revolutionary change on this front however. Instead, I suspect that equity infusions will require complicated individualized efforts to arrange for some time into the future.

Non-bank banks....

An interesting development that may turn out to be an iceberg's tip is occurring with nontraditional capital suppliers. Increasingly and at an increasing growth rate as well, nontraditional debt providers are taking market share away from traditional lenders (Dodson). The most obvious examples involve firms like John Deere and J.I. Case which each run vendor finance operations and have developed huge lending operations originally to support their merchandising operations. Interestingly, Deere has begun funding the vendor finance operations of other agribusinesses and at least one cooperative as well. Apparently they have found a profitable niche and have begun filling it to the advantage of their eventual customers who are largely the same customers of traditional lenders. Less obvious are firms like Ag Services of America who, in effect, substitute their wholesale borrowing capacity for their customers' collective debt and re-lend on terms that facilitate their other businesses. Feed companies are likewise showing up in more and more financing deals either providing credit enhancements or direct quasi-equity stakes. One need only consider the growth of G.E. Capital, or major leasing and acceptance corporations to at least spur interest in the potential effects in rural America if non-bank banking finds niches in otherwise underserved markets. In this regard, what is generally viewed as more numerous market imperfections and inadequacies at least includes the potential to attract entrepreneurial solutions.

Concluding Comments:

Even though the current rural economy is enjoying relatively stable and prosperous times, there remains appropriate concern to avoid actions that could regenerate the economic turmoil of the 1980s. And, there is concern that while improving, the rural economy is losing ground relative to its non-rural counterpart (Duncan). The future path of many rural communities includes a more diversified economic base and more concentrated business structures – both of which require new and perhaps different forms of capital. At the same time, financial markets are consolidating and becoming less "local" or "community based". On top of all of this, the government has adopted a posture of less direct involvement and has sent mixed signals about the future role and mechanisms for access to agency market funding for existing lenders. Accordingly, there are questions about the intersection of these trends. If capital providers are: (a) becoming less competitive at the same time that (b) governments are less active in developing new supporting institutions and (c) the needs of the customers are increasing and more specialized, then fairly bleak inferences could be drawn for the future of rural capital supply and use. On the other hand, if: (a) the evolution of the production sector is driven by efficiency and economic prospects, and (b) bank consolidations result in improved cost structures, and (c) the need for direct government involvement is declining, while (d) technologies are providing for broader, more uniform, and competitive access to a largely potential set of suppliers, then a contrastingly positive inference can be drawn. There has been a great deal of empirical work investigating the causes and effects of each of these trends individually. Likewise, there have been highly qualified individuals assembled in conferences charged with addressing these same issues. On balance, the evidence suggests we are more nearly on the latter path although the prospects for broadening the economic base toward more industrialized manufacturing may be somewhat unrealistic for much of rural America. Fortunately, there does not appear, nor does the horizon seem to signal, a credit crunch in rural

America. The local lenders face numerous constraints, and will continue to have liquidity and funding problems for managing asset-liability match, but the competing sources appear capable of filling in whenever gaps arise.

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