RURAL CREDIT.

REVIEW OF THE FIFTH REPORT OF THE RURAL RECONSTRUCTION COMMISSION.

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No feature of Australian agriculture has stood in more urgent need of investigation than the Rural Credit system. The economic hazards of the not-so-far distant depression years threw into sharp relief the faults inherent in the existing sources of supply of Rural Credit and made it clear that certain major modifications would be necessary before long. However, the processes of change were slow to work themselves out, and at the outbreak of war no great improvements had been made.

As an integral part of the economy, agriculture suffered all the inconveniences, all the adjustments made necessary by total war. But its importance in such a mighty effort was recognised and it received much help not usually afforded it in times of peace. In a sense, the war temporarily isolated agriculture from long-term trends and developments, but it now faces a return to a condition of world competitive markets and all the intricacies of international trade. In such a situation revision of agricultural credit systems becomes a matter of urgent necessity, if rural industry is to maximise its opportunities.

In Australia, we have been fortunate in having for our guidance at this time a Rural Reconstruction Commission set up to inquire into all aspects of agriculture and to make recommendations thereon. The Fifth Report of the Commission keeps up the standard of its predecessors, and must be rated as one of the best comments on the subject prepared in this country.

In the introductory chapter the key to the whole message of the report is contained in the following sentence:—

> "The lesson to be learned by farmers and suppliers of credit alike is that the productive capacity of any farm sets the limit of its capacity to meet credit requirements, notwithstanding its current market value or the value of any other assets used in operating it, and that abundant credit is not a remedy for a condition which is due to low prices, unsatisfactory farming, or an uneconomic farm."

This statement seems to summarise the very essence of the whole problem of Rural Credit. However, while thus emphasising that there is a limit to the debt which any farm can safely carry, it is well to remember the converse, namely that credit which gives rise to productive assets and from which the added production more than covers debt charges is sound credit, and, generally speaking, farmers need more of it.

General Principles.

The first section of the report on capital in agriculture and the demand for credit sets out clearly many valuable and basic principles. After commenting on the necessity of capital for modern productive enterprise the Commission points out that capital for agriculture takes three forms:—

(*a*) Basic Capital for Settlement and Development, *e.g.*, land and improvements, the capital involved in the basic productive agent, the farm itself.

(*b*) Equipment Capital—for agents of productive enterprise.

(*c*) Working Capital—required to assist the actual processes of production.

The demand for such capital fluctuates, of course, but the greatest fluctuations occur with working capital requirements. Improvements to land, the demands of mechanisation and the intensity of cultivation continue to increase the need for capital. Such assistance can only be secured by the farmer by way of loan or partnership, and in the former case he accepts a definite responsibility to make money payments available at regular intervals. These are the commitments which become "embarrassing in times of adversity." Now such payments have to be made from returns. It follows then that credit transactions need to be considered in relation to net returns from the productive enterprise. Also, net returns need to be related to Capital Value. The Commission proceeds to put the position thus: "Outstanding features of farming are the large number of farms which yield net returns, over a long period, of less than a fair commercial rate (say, 5 per cent.) on the market value of the capital, and the variation in percentage returns from different farms."

It follows that the loan limits of farms are not always proportional to the market value of the capital employed in them. What are some of the factors adversely affecting the net profit rate in relation to invested capital?

Firstly, the Commission mentions the influence of non-commercial attractions on the market value of farming properties. Here, its comments have telling significance. In very many cases such factors as land hunger, desire for security, the attainment of social prestige, have driven farm prices up beyond the earning capacity valuation and have thus perpetuated conditions of economic instability. Other factors are uneconomic farm size and the use of excess capital. Net earnings also vary at various stages of farm development.

Both lenders and borrowers have failed to see the importance of farm returns in deciding borrowing capacity. Over-borrowing and to some extent under-borrowing have been the result. This over-borrowing has caused many of the difficulties which are often used as a basis of representations for such claims as an all-round cheapening of interest rates and/or higher product prices. The Commission believes that a precise formula pinning down loan limits to a fixed proportion of capital value would be of little value. A figure must be arrived at bringing out clearly the relation of net returns on capital to the interest rate. Terms of repayment of principal amounts of loans must be related to the expected returns, so that, over the period of financial assistance, the farmer is not called upon to pay more than the balance left after covering his labour and interest commitments. Therefore, it is the Commission's view that since farm returns do fluctuate, the obligations to meet regular instalments should be capable of temporary adjustments as required by the nature of the returns.

Thus far the Commission concerns itself primarily with what are actually the undesirable features of a Rural Credit system. The analysis makes clear the way to suggested improvements by sparing no single significant cause of existing faults.

Desirable Credit Features.

The Commission then proceeds to a discussion of "Desirable Features of a Credit System." This section is probably the most important section of the whole Report. The method of approach used is to consider each of the services of credit and then to examine the efficiency of the credit structure as a whole.

Elasticity of Credit.

Firstly, the Commission refers to the elasticity of credit, *i.e.*, to the fluctuating demand for capital. There is an economic advantage for the farmer to have his changing demand for capital met by credit. He may be able to find the marginal outlay, but such a margin would lie inactive in good times. Subject to certain conditions, it is better for the marginal capital to be absorbed into the farm, and credit relied upon where necessary. But what of the elasticity of supply to meet the demands of a credit system? A wide diversity of demand may cause little change in the total demand for credit. But in Australia there are wide variations in seasonal and market conditions from year to year which often place a heavy strain on the existing sources of credit. The Commission's view is that these extra demands can be met only by a strong policy on the part of the Central Bank over the creation and distribution of credit plus sufficient confidence to create more if needed. Of course, the problem of the supply of Rural Credit is more than one of rural banking—it is related to general banking and other commercial activity.

Period of Loans.

Secondly, the Commission discusses the period of loans. This is all-important to the farmer. The capital provided must be available long enough to cover the period of production for which it is required. Extra costs are involved in seeking a renewal of a loan. If the time for renewal coincides with a period when credit is scarce, such renewal may become difficult or will be associated with payment of a higher interest rate. If a loan is repayable on a fixed date, the farmer may be embarrassed if due date coincides with bad market conditions. Furthermore, many farmers receive credit from a number of lenders, each with his own conditions of repayment. Such duplication may present serious difficulties if conditions are bad.

Risk of Embarrassment.

The third desirable feature of a Credit System, in the Commission's view, is the manner in which it serves the needs and comfort of the individual borrower. Such a system must try to minimise all risk of embarrassment. An example is given in the case of continuity of enterprise. A farmer may be preparing the soil for next season's crops before this season's crop has matured. If credit for cultivation of the new crops is not available before the debts in respect of the old one are discharged, there is a break in the continuity of production. Farmers frequently risk embarrassment by their choice of sources of credit. Some lenders will want the security of the most liquid resources. Others may not be able to stand the pressure of economic stress. The Commission believes that the farmer will suffer least embarrassment where—

(*a*) he obtains all his credit from one lender, with the possible exception of the most short-term requirements;

(*b*) the lender—

(i) is financially strong,

(ii) considers the farmer's needs as to length of loans and the elasticity of the credit,

(iii) is able to lend considerably on fixed capital before lending on working capital,

(iv) is organised in such a way that representatives are near the farmer, are competent to assess his requirements in advance and are able to give quick decisions in an emergency.

The Price of Credit.

The fourth specific feature of a worthy credit structure considered by the Commission is the price of credit. Credit is a service and has its own price—interest—to compensate the owners of capital for forgoing liquidity. The actual price of credit is determined by a number of factors—the general conditions of supply and demand for money, the length of time for which liquidity is surrendered, the risks involved, and the costs of servicing the credit.

General conditions of supply and demand affect all loan transactions. This means that the price of agricultural credit is linked with the price of credit in the general market.

Part of the price of credit is influenced by the extent to which the lender sacrifices liquidity. The more of his resources he makes available and the longer the period of the loan, the more he will value the surrender of such liquidity. Accordingly, other things being equal, a private lender would require a higher rate of repayment for a longer than for a shorter period. But agriculture needs long-term credit, and so the supply of credit has to be organised to shield the farmer from the individual's need for liquidity. This necessitates large intermediaries. Another method would be for the investor to be given bonds which he could sell on the open market if he wanted liquidity and still not affect total funds.

Risk.

Risk is a major factor in deciding the price of credit. The degree of such risk depends upon many factors. The supplier of credit protects himself against risk by adding something to his price. Two factors affect the degree of risk. These are:—

(*a*) The risk in the enterprise and the capacity to assess it. This risk will vary from district to district and even from farm to farm. There are natural risks—rainfall, crop perishability, etc., and personal risks. The lender's confidence in his capacity to assess risk is all-important. The greater the degree of confidence, the less the need for a margin of error.

(*b*) The adequacy of the security.

If a loan is made entirely on personal security, the lender assumes the risks associated with the personal qualities of the borrower. If the loan is made on the security of assets, risk will be less, and the more the assets cover the debt, the less the risk. This adequacy of cover in turn depends on the capacity to value the security, the margin between the loan and the value of the security, and the chances of a fall in the value of the security. This uncertainty as to valuation will affect the margin of security required, before it affects the price of credit which would be affected only when the margin of security is absent.

The loan transaction involves many services and their cost is influenced by proximity of the lender to the borrower, the scale of lending operations and the degree of efficiency attained. The handicap of remoteness can be lessened by a system of small banks, by local co-operative credit institutions or by large banks having branches. Efficient organisation would involve the economical use of resources, a free and elastic movement of funds, and economical methods of assessing security and risk.

General Desirable Features.

Having focussed its attention on the individual matters of credit service, the Commission proceeds to define the desirable attributes of a credit service considered as a whole. The Commission suggests that a low-rate credit service supported by the Government should be built into the credit system. To avoid adding to inefficiency, uneconomic farm-size, excess debt commitments, inadequate plant, the new service should only be made available conditional on the efficiency of the farmer, and the taking of all means to promote economic efficiency. Furthermore, everything possible should be done to secure and maintain confidence between lenders and borrowers.

Summary of Commission's Views on Credit System Structure.

The Commission summarises its views on what a Rural Credit system should be as follows:—

(*a*) Such a system must be broad enough to include all types of rural enterprise.

(*b*) The supply of credit must be elastic enough to meet the fluctuating needs for capital.

(*c*) Loan conditions should be related to the changing circumstances of individuals.

(*d*) Risk of embarrassment to freedom of enterprise and to continuity of production should be kept to a minimum.

(*e*) The price of credit should be kept at such a level that agriculture will not be placed in a disadvantageous position compared with other industries.

(*f*) In a system which depends on private enterprise the competition of the organised credit market should be sufficient to avoid the development of monopolies in particular fields.

Existing Credit Sources.

Section III of the Report gives a complete review of existing credit sources. The Commission wisely included private lenders and traders and agents alongside the more obvious lending organisations. The Commission made it quite clear that private lending does in fact often involve serious difficulties, *e.g.*, high initial costs, limited periods for loans, inflated land prices, individual opportunities for exploitation. Its most obvious drawback is that private lending is rarely made available for working capital and hence the farmer usually has to seek a second source of credit for this purpose. The use of private credit would probably be less frequently availed of were the views of the Commission on the flexibility of repayment terms given effect. Most of these comments apply to a lesser degree to the other lending authorities —banks, insurance and trust companies, etc.

The Commission's views on traders and agents as suppliers of credit are worth noting. It considers that traders and agents, especially the smaller and less prudent ones, can have a disturbing effect on the credit structure if their actions are not considered with care. The same depressing effect on the farmer is produced by machinery and store credit. The hire purchase of machinery is not well controlled. Costs are high, losses through rash lending are frequent, and hidden charges enter in. Moreover, the farmer's equity in the machinery is not well protected. As far as store credit is concerned, very often unnecessary risks are taken, prices have to be inflated generally to cover credit costs and losses, and, as the Commission points out, farmers tend to become "tied" to one store.

Referring to the trading banks, the most important source of agricultural credit in Australia, the Commission expressed the view that they do not give sufficient consideration to projects in stages of development, farmers with small capital, and tenant and share farmers. Trading banks could ease the burden of the small farmers by modifying the overdraft system. The Commission felt that three problems have to be overcome as far as trading banks are concerned:—

(*a*) Over-lending in prosperous times.

(*b*) Pressure of withdrawal in bad times.

(*c*) Slowness sometimes in reaching decisions.

Speaking of Government banks and agencies, the Commission pointed out that they have many and various forms but have suffered from a lack of planned development and co-ordination.

Views and Recommendations.

Having considered desirable and undesirable features of a credit system, and then proceeded to look at the existing conditions in Australia, the Commission had cleared the ground for its own suggestions. It made fourteen (14) recommendations in all, on the following points:—

1. That the Commonwealth and State Governments recognise the need for specialised rural credit services.

2. That certain general principles should be adopted, *i.e.,* that a Rural Bank Service should be brought into being, that a Development and Reconstruction Service should be organised and administered by the Rural Bank, and that all existing Government credit schemes should be transferred to the new authority.

   New South Wales already has a Rural Bank performing most, if not all, of these suggested functions.

3. That the details of the Commission's Fourth Report should be the basis for the establishment of the new credit service.

4. That Commonwealth and State Governments should co-operate by agreement and with appropriate legislation to recognise the sphere assigned to each, with the Commonwealth exercising supervision through the Central Bank and providing finance for approved credit intermediaries including the State Rural Banks.

5. That Commonwealth and State authorities should co-operate through the Loan Council, striving for uniform interest rates, and that they should constitute a Consultative Council. The Commonwealth Bank would provide a special Rural Credits Department to administer loans to the State Banks, to act in an advisory capacity and to carry out research into rural credit.

6. That the Mortgage Bank Department of the Commonwealth Bank should not enter into competition with State Rural Credit authorities.

7. That the activities of the Savings Banks of Victoria and South Australia in fixing long-term rural mortgage lending should cease.

8. That existing State Agricultural Banks should be reorganised to conform with the recommendations of the Commission.

9. That where the Crown makes available Crown land, the practice of selling the land on terms, without regard to subsequent credit dealings by the settler, should be discontinued and either the land be sold for cash through the Rural Bank or the Bank should administer the account so that the land should not subsequently be charged for debt without its knowledge and consent.

10. That Governments should make all special purpose advances through the Rural Bank.

11. That the practice of making supplementary credit to necessitous farmers available from public funds should be discouraged and only be resorted to in extreme emergencies. In all other cases, the Bank would exercise this function.

12. That all debt adustment schemes should from now on be carried out by the Bank.

13. That the operations of the English Agricultural Credits Act (1928) be investigated to see how far the introduction of its principles to Australia would help to encourage farmers to use direct bank credit for equipment and working capital to enable them to take advantage of cash terms offered by traders.

14. That in all agricultural trading transactions whether of the nature of sale or of payment, it shall be a requirement of law that the cost of credit should be clearly and separately indicated.

One part of recommendation five on research is technically important to all the other clauses, namely, that a Public Information Service on Credit Facilities should be created. It seems evident that the entire success of any wide changes in the credit system will depend upon all parties—financial institutions, the farmers themselves, and even the general public—being well informed on the basic principles covered in the Commission's Report.

A General Comment.

It is clear that the Commission has faced up to the most important aspects of the problem of agricultural credit. It has placed great emphasis on its central theme—that credit capacity has to be related to productive capacity—if serious difficulties are to be avoided. It is almost unique to see returns being given their due importance as the basis for deciding terms and conditions of loans. This approach links credit movements with all the personal, climatic and economic factors which do in fact decide the prosperity or otherwise of any country's agricultural system, Credit must be cheap and its distribution efficient, But it is one thing to raise a problem, and another to solve it. This has been said of so many things that it has become a truism. However, in this case, the gap between theory and practice has been bridged. The Commission has discussed principles and the need for adjustment to meet them, but, even more important, it has successfully provided for the practical application of those principles with a wealth of detail which completely covers the suggested objectives. Alterations in the existing machinery are provided for, and additions are suggested, the net outcome being that no major segment of the pattern of Australia's future Rural Credit system has been overlooked. Of course, much will depend on the degree of co-operation arrived at between Federal and State authorities.

The way to a rational credit structure for this country has now been clearly indicated. It is for all concerned to apply themselves to the details of working to the suggested goals. It is therefore interesting as a final remark to observe that discussions are at present proceeding on ways and means to take the required steps for the implementation of the recommendations contained in all the Reports of the Rural Reconstruction Commission, including that on Rural Credit.