Statement of

Nathan S. Kauffman

Assistant Vice President, Economist, and Omaha Branch Executive

Federal Reserve Bank of Kansas City

Before the

U.S. Senate Committee on Agriculture, Nutrition, & Forestry

May 25, 2017

Chairman Roberts, Ranking Member Stabenow, and members of the committee, thank you for the opportunity to testify today. My name is Nathan Kauffman, and I am an economist and Omaha Branch Executive with the Federal Reserve Bank of Kansas City, a regional Reserve Bank that has long devoted significant attention to U.S. agriculture. In my role, I lead several Federal Reserve System efforts to track the agricultural economy, with a focus on farm finances and agricultural credit conditions. Our Bank is committed to including perspectives from rural America in discussions on the national economy, and I am here to share recent developments in the U.S. farm sector. Before I begin, let me emphasize that my statement represents my views only and is not necessarily that of the Federal Reserve System or any of its representatives.

At a high level, the U.S. farm economy has weakened notably over the past several years. The primary cause of the downturn that began in 2013 was a sharp drop in agricultural commodity prices, and this remains a top concern in the agricultural community. In a recent survey of agricultural banks conducted by the Kansas City Fed, about 85 percent of lenders in our region in the central United States identified the current environment of low commodity prices as a leading concern. In addition, while agricultural commodity prices have dropped sharply and remain low today, farm sector input costs have declined only gradually, and profit margins generally have remained weak.

Reduced profitability has gradually intensified the level of financial stress among farm borrowers. Nationally, debt-to-asset ratios and farm loan delinquency rates have edged higher over the past year, but only slightly. Federal Reserve data also show that the rate at which farm loans are being repaid has fallen steadily in each of the past four years alongside persistent increases in borrowers' financing needs.

The degree of financial stress in the farm sector, however, has varied regionally. In the first quarter of this year, nearly 60 percent of agricultural bankers surveyed in Colorado and the western portions of Nebraska, Kansas, and Oklahoma reported that loan repayment rates had fallen from the previous year. This is a region that is highly concentrated in cattle and wheat production. In contrast, only 25 percent of respondents in the eastern portion of our District, a region that is more concentrated in corn and soybean production, reported lower repayment rates.

Other measures of agricultural credit conditions in our region tell a similar story and are consistent with other parts of the country. This is to say, financial stress in the farm sector has increased more significantly in regions where cropland is generally less productive and in regions concentrated in markets that have been particularly weak, such as cattle and wheat. In other areas, strong crop yields last fall resulted in cash flows that were better than expected, and financial conditions have been more stable recently in those regions.

In a similar vein, farm real estate values have also declined the past few years, but only at a modest pace, and regional disparity has also been notable. Federal Reserve surveys show that the average value of high quality cropland has fallen by about 10 to 20 percent since 2013 in states with a high concentration of crop production. Since the beginning of 2015, however, farmland values have decreased more significantly in regions where the land is considered to be less productive or where the local farm economy has weakened more dramatically.

Despite regional variation, the relative strength in farm real estate markets has likely shielded the farm economy from potentially more severe financial stress, since farmland accounts for more than 80 percent of the value of farm sector assets and is an important source of collateral for other farm loans. The strength in land values has given agricultural lenders some opportunities to work with borrowers by restructuring loans and requesting additional collateral in response to heightened risk in their loan portfolios.

To briefly summarize, the U.S. farm economy is in the midst of a prolonged downturn, and financial stress in the farm sector has risen gradually over the past few years. Despite recent signs of stabilization in some areas, farm income has continued to decline overall due to persistently low agricultural commodity prices and elevated production costs. Alongside the reductions in farm income the past four years, agricultural credit conditions have weakened steadily and farm real estate values have trended lower. In general, I expect these downward trends to continue in the near term as global supplies are likely to continue to weigh on agricultural commodity prices and profit margins. Although a farm crisis does not appear imminent, some regions appear to be notably weaker than others, and there are still risks that could lead to more widespread challenges in the coming years.

# Federal Reserve Bank of Kansas City: Survey of Ag Credit Conditions (May 2017)

"Regional Farm Sector Stress Intensifies"

By Nathan Kauffman, Assistant Vice President and Omaha Branch Executive
and Matt Clark, Assistant Economist

## Summary

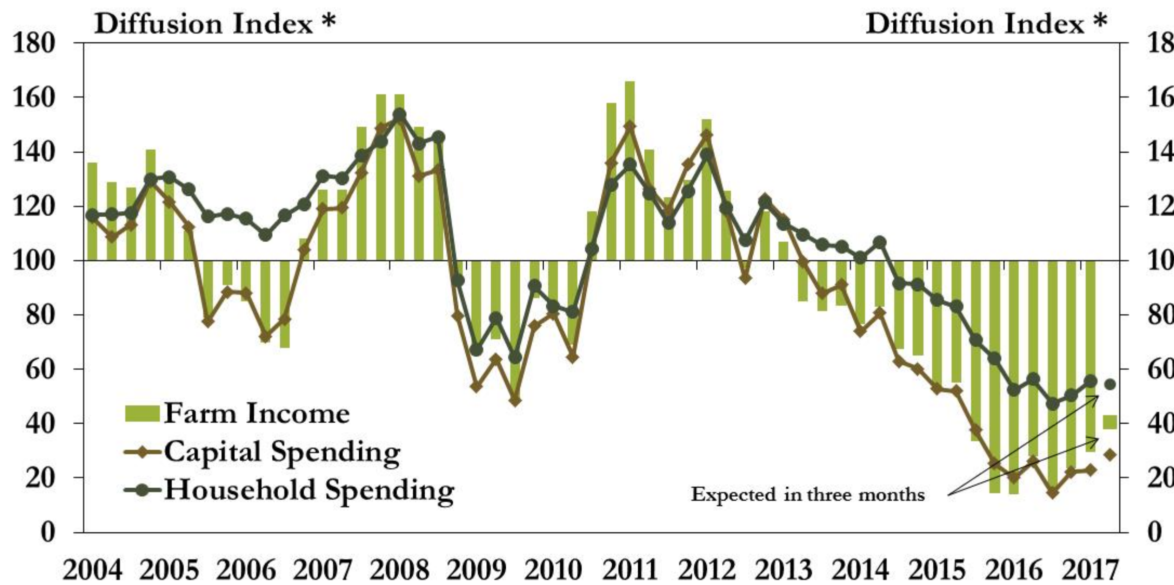
The farm economy in the Tenth District weakened in the first quarter of 2017, but conditions varied from east to west. Farm income, loan repayment rates and the value of most types of farmland all trended lower in each of the District's seven states. However, the deterioration in the western portion of the District was more severe than the moderate weakness in the eastern portion. Although agricultural credit conditions were weaker throughout the region, much of the recent weakness has been driven by intensifying challenges in the western portion of the District.

## Farm Income

Farm income in the Tenth District continued to decline in the first quarter, but at a slightly slower pace than in recent quarters. According to the survey, 73 percent of bankers reported farm income was lower than the year before. The decline in the first quarter marked the fourth consecutive year that District bankers reported farm income was lower than a year earlier (Chart 1). Despite the persistent decline, the pace of softening appeared to slow in the first quarter. For example, 24 percent of bankers indicated farm income remained unchanged from the previous year, the largest share since the third quarter of 2015. Bankers expected farm income to decline further in the coming months, but also at a slower pace than in recent quarters.

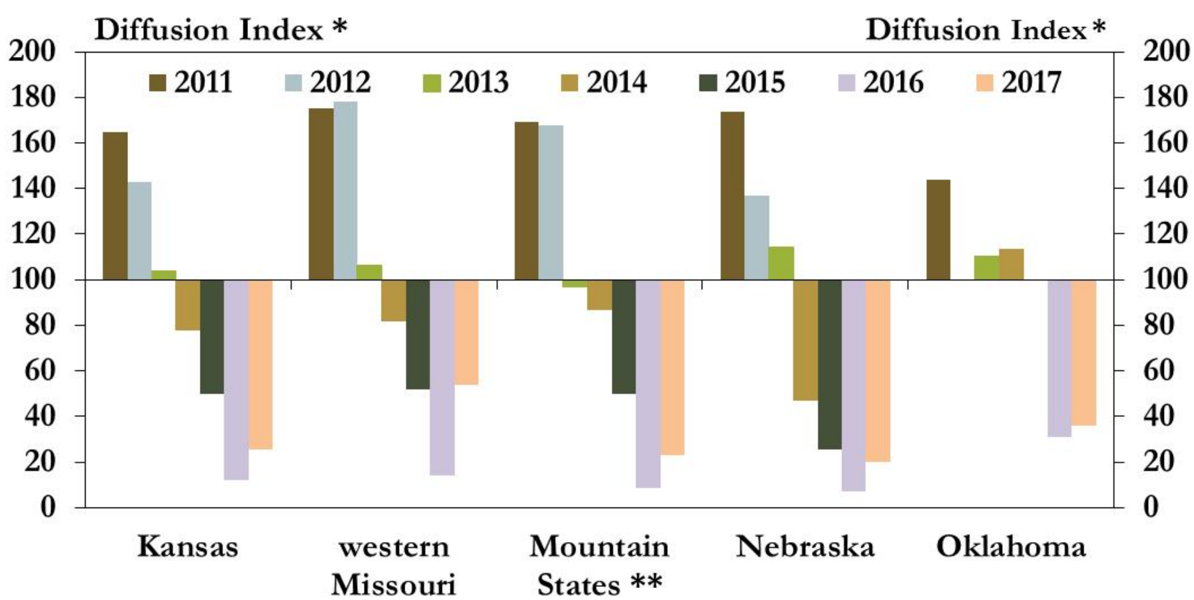
Similar to a year ago, bankers indicated that farm income had declined in each state in the Tenth District. Despite a recent rebound in cattle prices, a prolonged downturn in cattle and wheat markets caused bankers in regions with a strong concentration in those markets to express concerns about the local farm economy. In particular, farm income remained subdued in Kansas and the Mountain States, regions with relatively more cattle and wheat production (Chart 2). Although farm income continued to decline in western Missouri, bankers were slightly more optimistic in their assessment for farm income in that region, where crop yields were particularly strong last fall.

**Chart 1: Tenth District Farm Income and Spending**




*Bankers responded to each item by indicating whether conditions during the current quarter were higher than, lower than or the same as in the year-earlier period. The index numbers are computed by subtracting the percentage of bankers who responded "lower" from the percentage who responded "higher" and adding 100.

**Chart 2: Tenth District Farm Income, First Quarter**

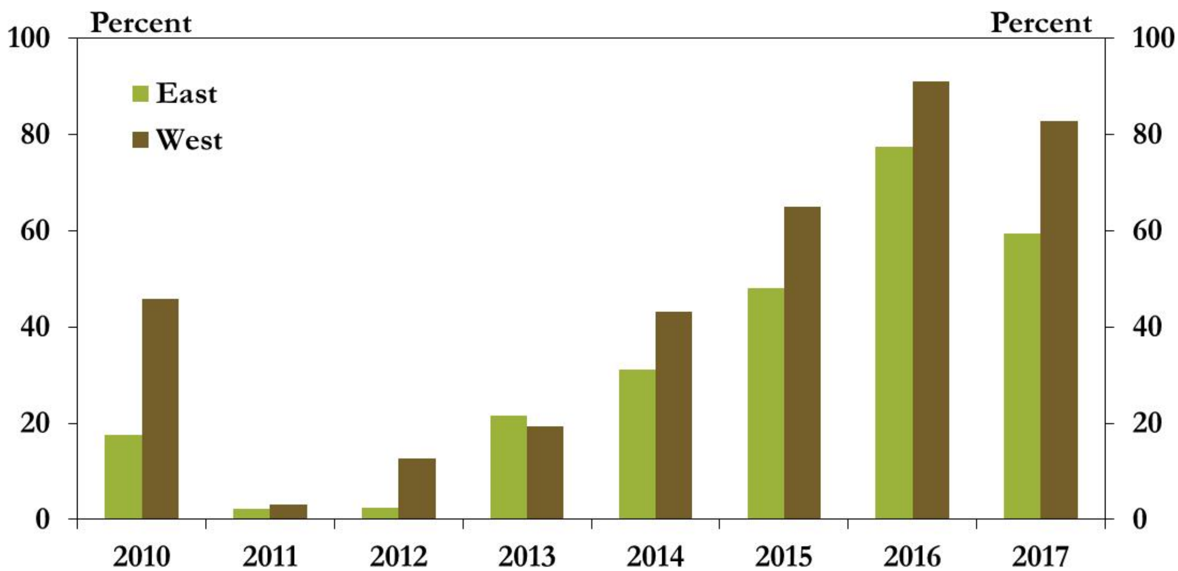



*Bankers responded to each item by indicating whether conditions during the current quarter were higher than, lower than or the same as in the year-earlier period. The index numbers are computed by subtracting the percentage of bankers who responded "lower" from the percentage who responded "higher" and adding 100.

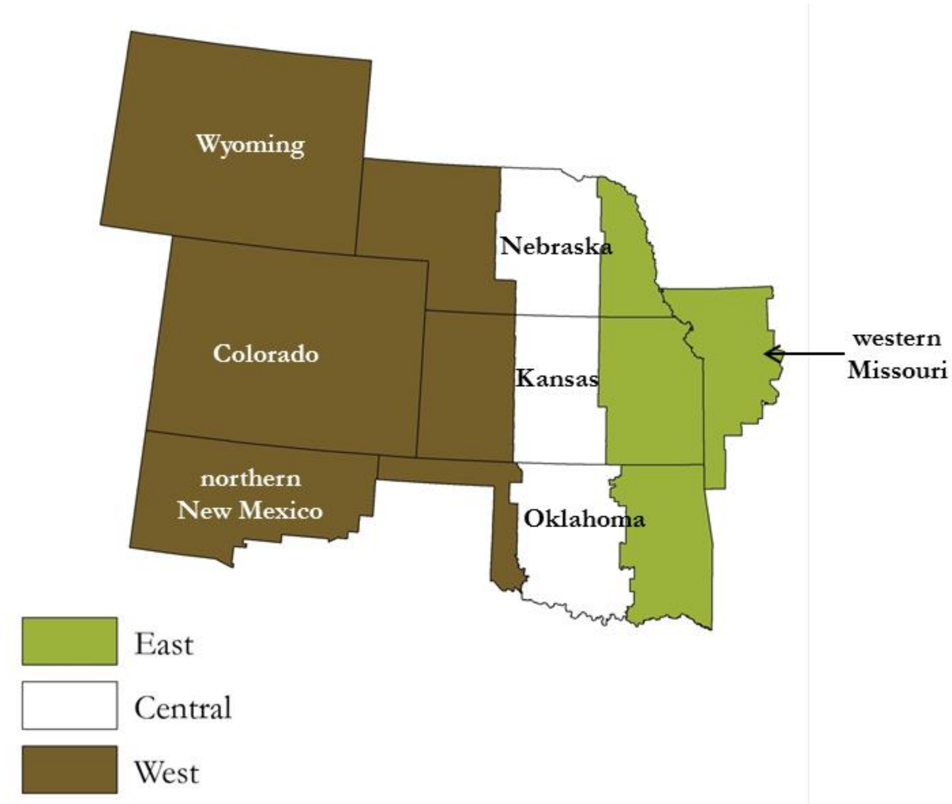
** Mountain States include Colorado, northern New Mexico and Wyoming, which are grouped because of limited survey responses from each state.

More generally, farm income has declined at a stronger pace in the western part of the District. Since 2014, following a drop in the prices of major row crops, farm income has fallen more sharply in the Mountain States and the western portions of Nebraska, Kansas and Oklahoma (Chart 3 and Map). According to the survey, the gap in the performance of the farm sector between the District's eastern and western portions widened in the first quarter. Alongside persistent weakness in cattle and wheat markets, more than 80 percent of bankers indicated farm income was lower than a year ago in the western part of the District versus about 60 percent in the eastern part.

**Chart 3: Tenth District Farm Income, First Quarter**
Share of Bankers Reporting Lower Farm Income



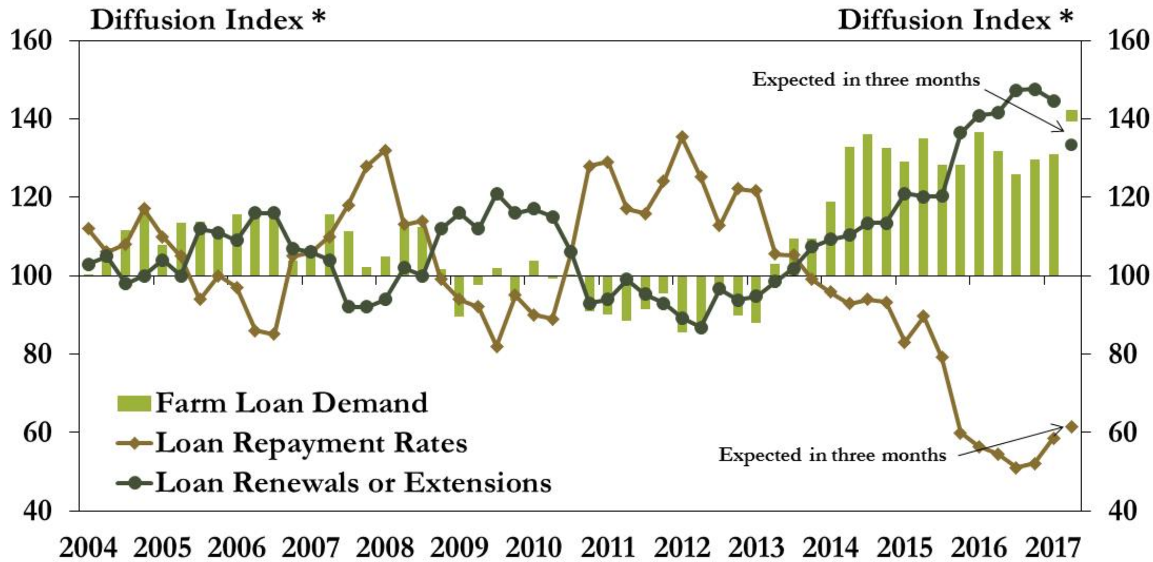
**Map: Tenth Federal Reserve District**



**Credit Conditions and Lending**

A prolonged downturn in the farm economy continued to weigh on agricultural credit conditions in the District, but also at a softer pace than in recent quarters. Loan demand remained high in the first quarter and was expected to continue to rise in the coming months (Chart 4). Bankers also reported farm loan repayment rates continued to weaken, but not as sharply as in 2016. In fact, similar to farm income, 49 percent of bankers indicated loan repayment rates were unchanged from a year ago, a larger share than the previous two quarters.

**Chart 4: Tenth District Credit Conditions**



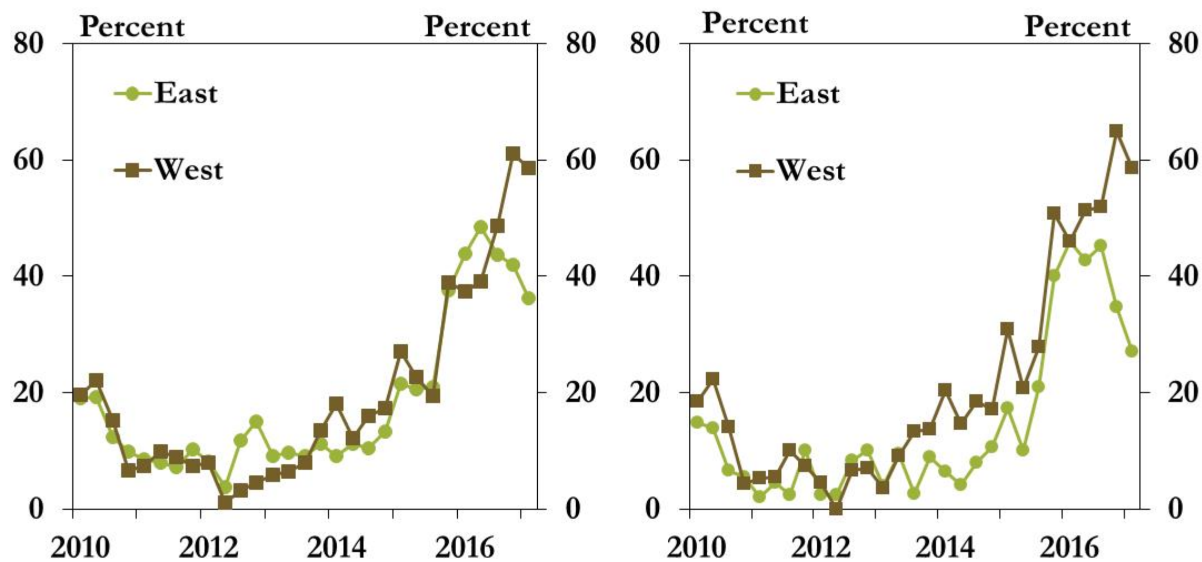

*Bankers responded to each item by indicating whether conditions during the current quarter were higher than, lower than or the same as in the year-earlier period. The index numbers are computed by subtracting the percentage of bankers who responded "lower" from the percentage who responded "higher" and adding 100.

Despite some signs of optimism in the eastern portion of the District, agricultural credit conditions worsened more significantly in the west. Over the past several years, the share of bankers reporting higher rates of loan renewals and lower repayment rates had been similar throughout the Tenth District (Chart 5). Since mid-2016, however, the rate of deterioration in these two metrics has increased in the west, but generally has softened in the east, reflecting an emerging regional divide in agricultural finance conditions. Whereas bankers throughout the District have expressed ongoing concerns about the state of the farm economy, concerns from bankers further west have been elevated and were reflected in the recent survey data.

**Chart 5: Tenth District Credit Conditions**

Share of Bankers Reporting Higher Renewal/Extension Rates

Share of Bankers Reporting Lower Repayment Rates




The pace of carry-over debt also quickened in the western portion of the District, but declined in the east. In 2016, about 29 percent of farm borrowers carried over more debt from the previous year (Chart 6). In the first quarter of 2017, however, more than 40 percent of bankers in the west noted that carry-over debt increased, while less than 20 percent in the east reported an increase in borrowers with carry-over debt. In addition, the share of agricultural loans that involved debt restructuring in response to persistent shortages in cash flow increased again in the west, but generally remained stable in the east (Chart 7).

Alongside ongoing difficulties in the District farm economy, bankers continued to raise collateral requirements and interest rates for farm borrowers at a modest pace. In the first quarter, nearly 40 percent of bankers noted that collateral requirements increased from the year before, reflecting a steady increase from recent years (Chart 8). Interest rates remained historically low, but increased 24 basis points, on average, for variable rate operating loans and 15 basis points for fixed rate operating loans from a year ago (Chart 9).

**Chart 6: Borrowers with an Increase in Carryover Debt, First Quarter**

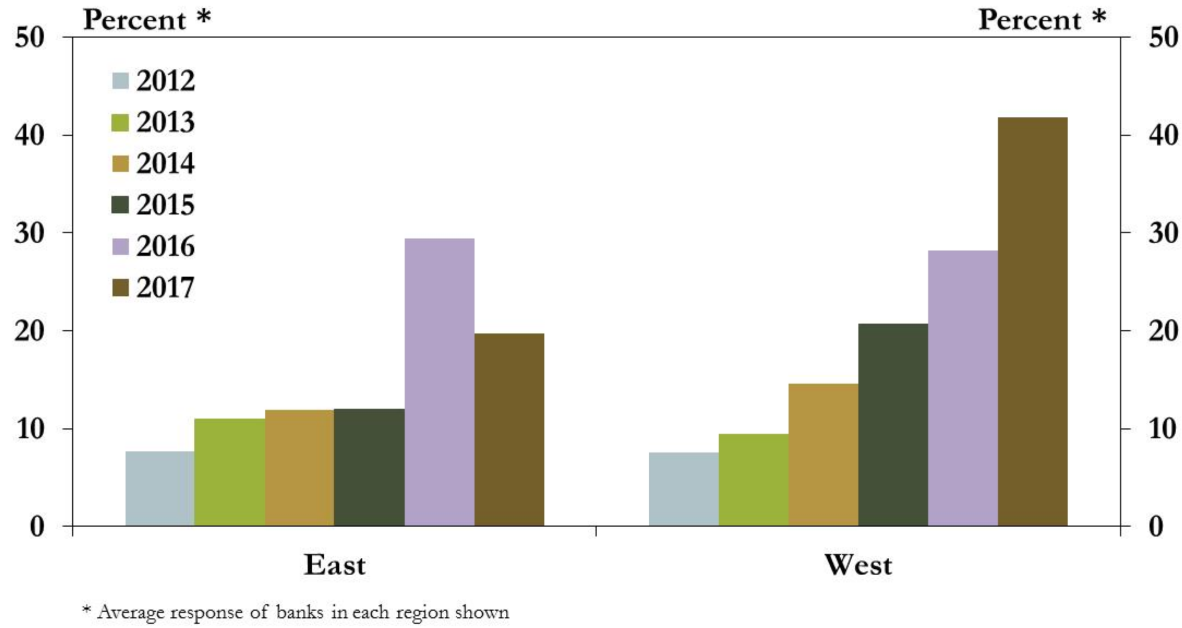



**Chart 7: Share of Agricultural Loans Originated Involving Debt Restructuring**

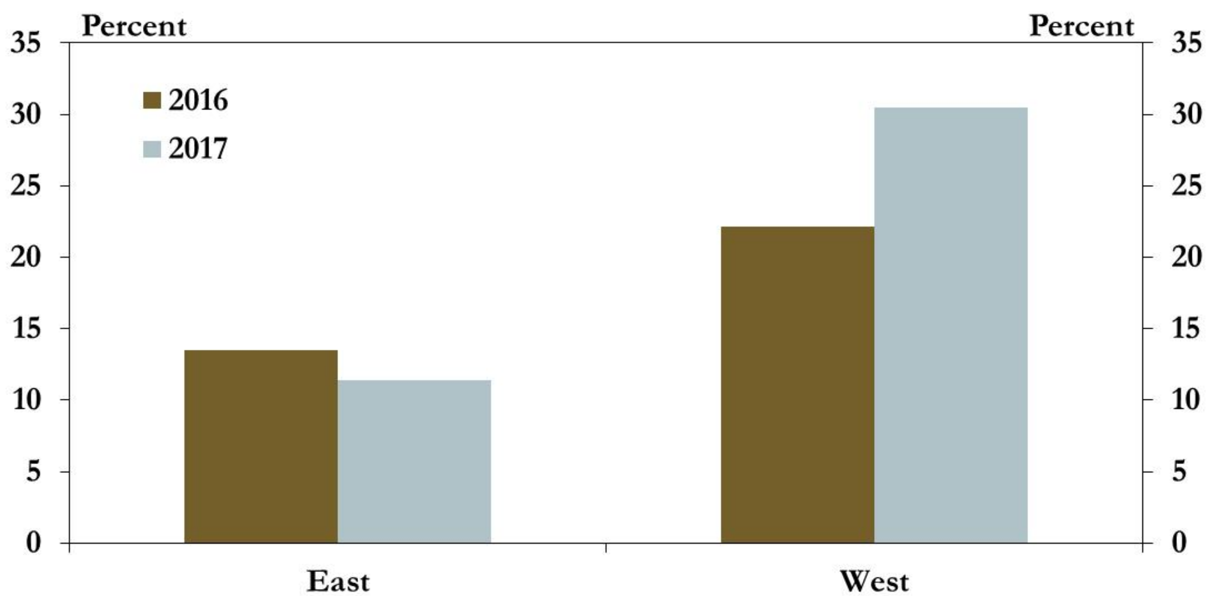


**Chart 8: Collateral Requirement Changes Relative to One Year Ago**

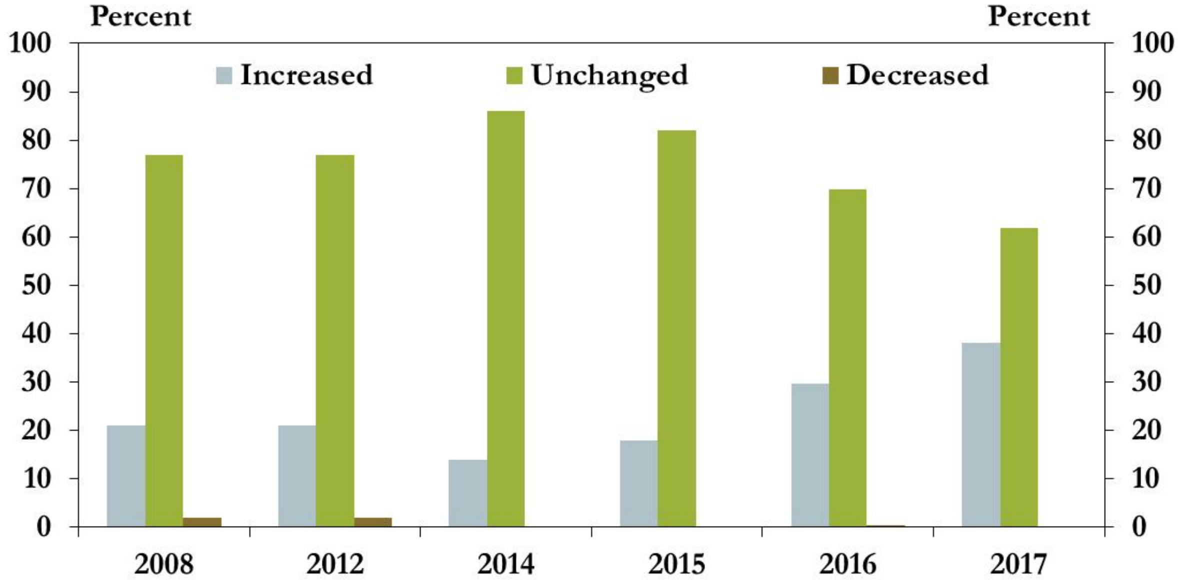
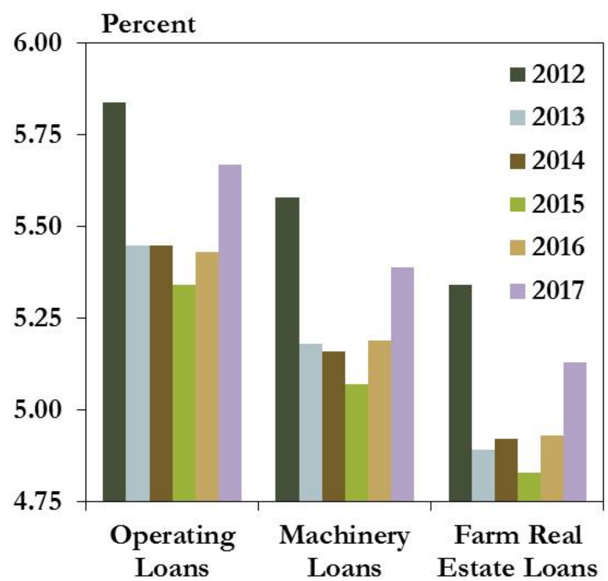
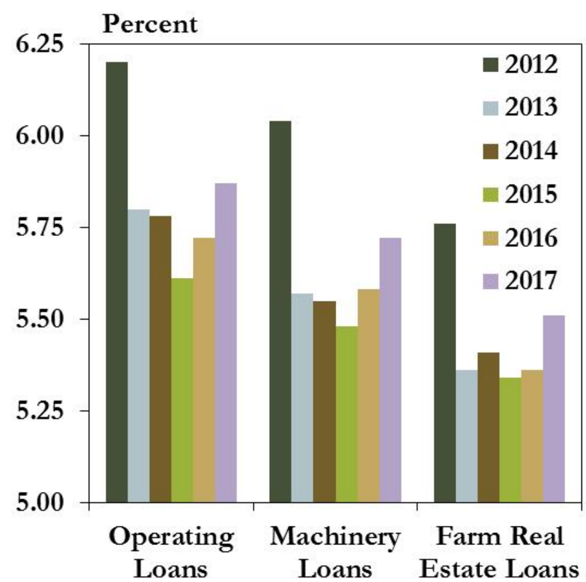



**Chart 9: Tenth District Average Interest Rates, First Quarter**

Variable Interest Rates



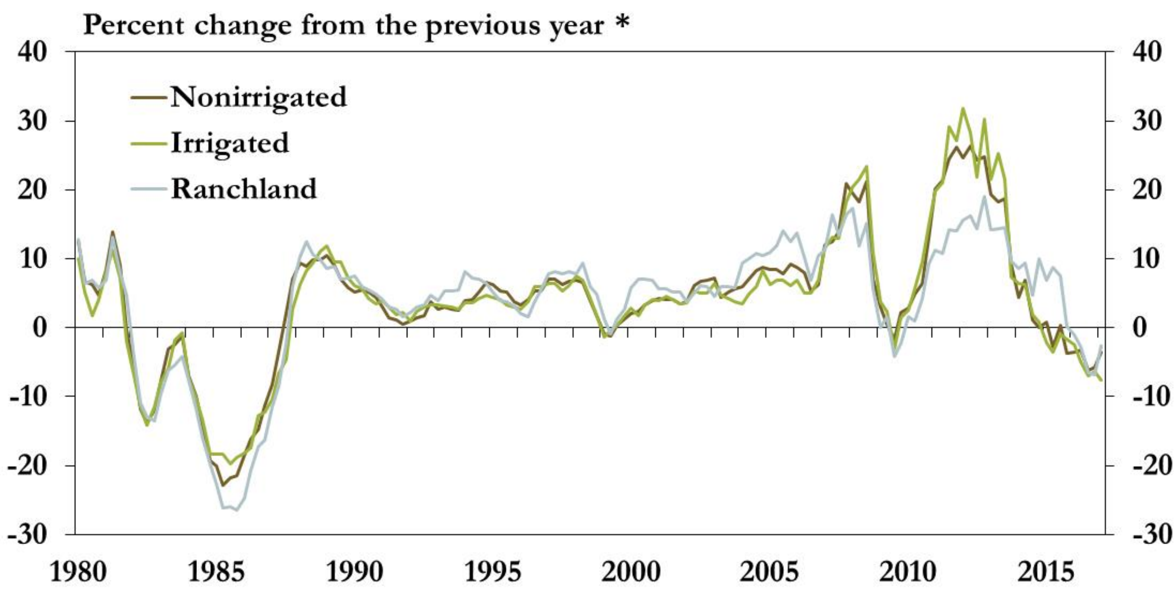

Fixed Interest Rates



## Farmland Values

As expected, based on recent surveys, District farmland values trended lower in response to conditions in the regional farm economy. The value of nonirrigated cropland declined 3 percent in the first quarter, following similar declines in 2016 (Chart 10). The value of irrigated cropland and ranchland also decreased in the first quarter. Although farmland values continued to trend lower alongside ongoing weakness in the farm economy, the declines have remained relatively modest in comparison to the crisis of the 1980s.

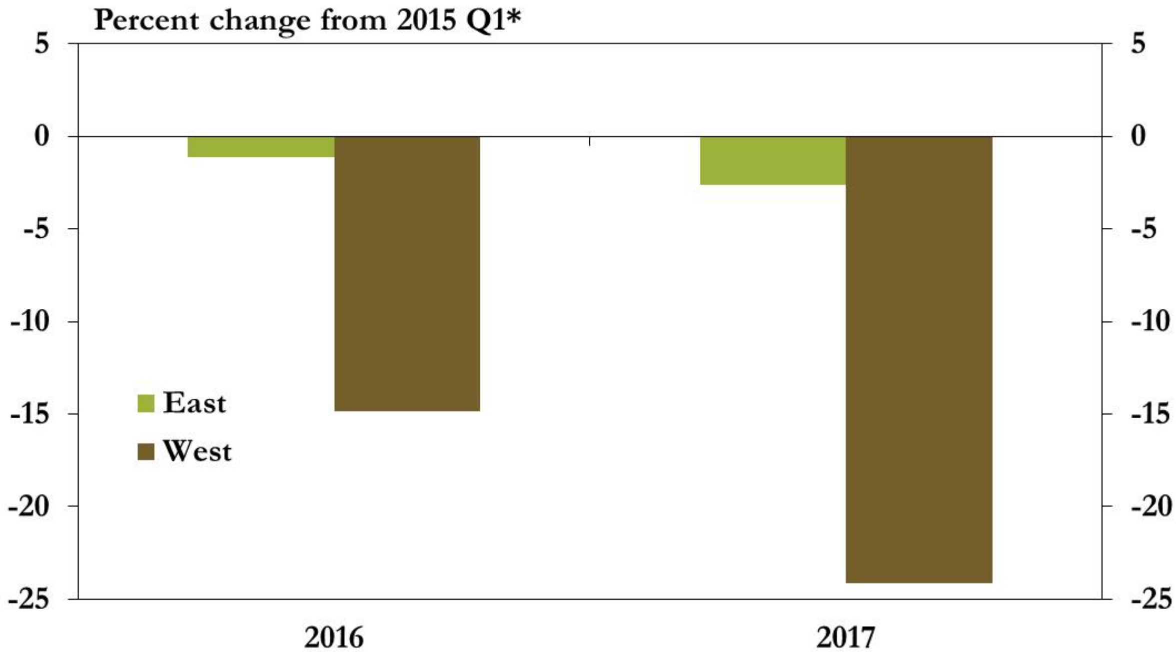
**Chart 10: Tenth District Farmland Values**




* Percent changes are calculated using responses only from those banks reporting in both the past and the current quarters.

The recent declines in farmland values in the Tenth District, however, also have been sharper in the west. The value of nonirrigated cropland began to soften in 2013 throughout the District, but recent declines have been more substantial in the west (Chart 11). In fact, according to the survey, nonirrigated cropland values have fallen only 3 percent in the east since the first quarter of 2015, but have dropped 24 percent in the western portion of the District.

**Chart 11: Tenth District Nonirrigated Farmland Values**




* Percent changes are calculated using responses only from those banks reporting in both the past and the current quarters.

## Conclusion

In the first quarter, bankers throughout the Tenth District indicated that profit margins and cash flow remained tight. However, financial stress among agricultural producers and concerns among lenders have become more regional as economic conditions have worsened more significantly in the western portion of the District than in the east. As the farm economy remains under pressure, it is possible that challenges may intensify in some regions even as conditions may begin to stabilize in other areas.