Surviving the Next Farm Financial Crisis[i]

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Prices for virtually all farm commodities were at near record highs during 2007, and until a few weeks ago, were projected to continue at near record levels into the future. Prices for major U.S. crops – including corn, soybeans, wheat, and cotton – doubled between 2002 and 2007 with much of the increase coming during the past two years.[1] Livestock prices were up 50% during the same period, again with much of the rise coming within the past couple of years.

These price increases were the result of a number of factors, including relatively tight global grain supplies. Commercial storage of grains has been as historic low levels the past few years, as the big grain companies have not wanted to carry inventories over into new harvest seasons. This has left grain markets vulnerable to even the modest shortfalls in global production that occur periodically due to drought or other act of nature. Global demand has been influenced primarily by booming economies of the newly developing nations, particularly China and India. Historically, as peoples' incomes rise, they eat more meat, milk, and other animal products, diverting farmland from *food* grains to *feed* grains. Far more land, energy, and money are required to produce the grain needed to produce a calorie of meat or milk than is required to produce a calorie of rice or wheat. Thus, an increase in consumption of animal products results in a reduction total food production from a given amount of land, energy, and money. Rising commodity prices are the market's way of rationing the resulting scarce supplies, while providing incentives for farmers to increase production, if additional land, energy, and money are available to do so.

However, the diversion of corn from a *feed* grain to a *fuel* grain, specifically for ethanol, has been the most significant change in market conditions during the past two years, the time of most rapidly rising grain prices. The diversion of soybeans for food and feed to biodiesel has also been significant but far smaller. The USDA has projected that about one-third of the 2008 U.S. corn crop will go to ethanol production, and the U.S. is the world's largest producer of corn. Even after accounting for the distiller grain fed to cattle, the net reduction in livestock feed due to ethanol production would be close to one-quarter of the U.S. corn crop. U.S. corn production in 2008 is projected to increase by nearly enough to offset the increased demand for ethanol production. However, the increased acres of land used for corn have been diverted from producing soybeans, wheat, and other food crops, thus causing the prices of those crops to rise accordingly.

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This same kind of diversion has been occurring in all major agricultural nations of the world, thus triggering the dramatic rise in grain and food prices over the past two years. Food prices have risen far less than prices of agricultural commodity, primarily because for most people the costs of raw commodities – corn, wheat, rice – make up a relatively small portion of total food costs. For example, processing, transportation, advertising, packaging, and such account for 80% of total food cost in the U.S. In many countries of the world, however, people prepare their meals "from scratch." The costs of grain and livestock products account for nearly all of their food costs. Consequently their food costs have risen much more dramatically than in the U.S.

The margin between scarcity and surplus in food markets is very thin and fragile. People don't eat a lot more food, even when prices fall to sharply lower levels, we simply don't have the physical capacity. Likewise, when prices rise sharply higher, people still have to eat. So a seemingly modest change in food availability can result in dramatic changes in prices for basic food item – grains, meat, and dairy products. In times of global surpluses, the ethanol effect might have been minimal. In times of global scarcity, however, ethanol production provided the trigger for rising grain prices and increasing global hunger. Livestock producers have responded to the reduced profits associated with higher feed grain prices by cutting back on production. Livestock production cuts take time; so, livestock price increases have lagged rising crop prices, but nonetheless, have moved sharply upward.

Rising commodity prices have sparked economic optimism among U.S. farmers, even though rising costs have kept farm profits from rising as fast as commodity prices. Until recently, agricultural experts had expected the growing global demand for feed grains to extend well into the future, as emerging economies continue to grow. In addition, an increasing demand for ethanol has been built into U.S. government policy through renewable energy mandates and subsidies. Public concerns about the ethics of diverting food crops to fuel crops have caused some concern about corn-based ethanol, shifting the focus to cellulosic ethanol. More recently, financial uncertainties in the U.S. and plummeting stock markets have created more clouds on the agricultural horizon. Until quite recently, however, optimism has been the prevailing mood in American agriculture.

The most objective measure of this optimism has been higher prices of U.S. farmland. The latest USDA annual survey indicated a record high average price of $2,500 per acre on January 1, 2008, with most farmland in the Corn Belt priced at $4,000-$5,000 per acre.[2] This reflects a doubling of prices since 2001, three-fourths of the increase coming in the past four years. Higher land prices have been filling the countryside with new millionaire farmers, or at least millionaire land owners. Nearly half of all land farmed in the U.S. is rented rather than owned, but high land rents have not dampened farmers' enthusiasm for planting fencerow to fencerow. Many are putting land previously set aside under the Conservation Reserve Program back into crop production as quickly as their contracts expire. The last time we saw such prosperity and such optimism in rural America was more than 30 years ago, during the 1970s.

The 1970s was another time when booming exports markets and a booming global economy brought prosperity to American agriculture. The cost of U.S. agricultural commodities to foreign buyers fell dramatically when the U.S. dollar plunged in value relative to other currencies after

fixed exchange rates were abandoned in 1972. The big Russian grain deal of 1972 was but the most publicized of U.S. grain sales that signaled the opening of global markets to U.S. exports. Government farm programs during the 1970s reduced farmers' risks of overproduction, as government price supports rose with market prices. The government also encouraged expansion through generous farm credit and lending programs. Nominal interest rates were high, but inflation rates were even higher, meaning that the cost of borrowing money was negligible during most of the decade. Prices of farmland set new records year after year during the 1970s. Farmland was considered a safe investment and thus sound collateral for loans. The U.S. had not experienced a reduction in farmland prices since the great depression of the 1930s.

Storm clouds were on the horizon during the 1970s also, but they were largely ignored. The formation of OPEC had curtailed global petroleum production and prices of oil and gasoline had risen sharply. Domestic oil production in the U.S. had peaked in 1971, thus a growing dependence on high-priced foreign oil was unavoidable. The U.S. government responded by freezing gasoline prices, resulting in long lines at gas pumps. Reductions in speed limits, auto mileage requirements, and other energy conservation measures followed, but such measures took time to affect demand. In the meantime, the Federal Reserve put enough additional money in circulation to cover the higher costs of energy. Skyrocketing inflation rates followed – the logical consequence of increased government borrowing and spending, coupled with sluggish economic growth. The situation was exacerbated by a festering conflict between the U.S. and Iran over U.S. access to Middle East oil. Jimmy Carter's "crisis of confidence" speech, the Iranian hostage crisis, and the election of a new President brought the decade to a close.

Ronald Reagan came into office with a promise to rein in inflation and restore prosperity. He reversed Carter's economic policies. The Federal Reserve tightened the money supply, interest rates rose still higher, at least for a time, but the economy went into a recession and inflation rates fell. Interest rates eventually fell also, but not by as much as inflation. The cost of borrowing money rose from virtually nothing, during the high inflation years, to record high levels within a matter of months. With high *real* interest rates, the value of the U.S. dollar rose sharply, dramatically increasing the cost of U.S. agricultural commodities in world markets. As the U.S. economy slipped further into recession, the global economy followed, resulting in the virtual collapse of the developing economies that had accounted for much of the growth in U.S. agricultural exports. Prices for U.S. farm commodities fell even faster than they had gone up.

U.S. farmers were caught with large debts. Most farm loans were locked in at record high *nominal* interest rates from the 1970s, which with low inflation rates, were now record high *real* interest rates. Falling prices left farmers with no profits and thus many were unable to make their loan payments. Prices of farmland fell, and fell sharply, for the first time since the '30s. As a result, the debts of many farmers exceeded the value of their land. Record numbers of farmers went through bankruptcies, foreclosures, and voluntary liquidations. The effects of these farm failures rippled though rural America, as many communities suffered through the degradation and destruction of their economic, social, and cultural basis for existence. Once-viable farming communities became ghost towns. The "farm financial crisis" of the 1980s became routine fare on the nightly network newscasts, punctuated by occasional farmer suicides. Farming communities across the country suffered through hard times not seen since the great depression.

Could the same thing happen again? There is no way to foretell the future with a high degree of accuracy. The world is simply too complex to anticipate the net result of all of the potentially interrelated factors that go into making economic booms and busts. However, the economic principles that underlie booms and busts are fairly simple and quite clear. From everything we learned, or should have learned, from the 1970s and 1980s, another "farm financial crisis" seems far more likely than not. Hopefully, we learned some things during the Great Depression of the '30s that will at least lessen the impacts of the current financial melt-down on Wall Street and the upcoming recession on Main Street. However, the farm financial crisis of the 2010s could be even worse than the crisis of the 1980s.

The U.S. economy was still fundamentally sound in the early 1970s. Inflation was simply the reaction of a country in denial. The American people were simply not ready to accept the fact that they were going to have to pay high prices for Middle East oil, one way or another, and there was nothing they could do about it. If prices of everything else went up, however, the *relative* price of oil wouldn't *seem* so high. The inflation of the 1970s was intentional; it just got out of control. Even when the economy began to struggle and "stagflation" set in, the U.S. federal budget and trade deficits were still historically low and the manufacturing and agricultural sectors of the economy were fundamentally sound.

After 30 years of continuing denial, however, the U.S. economy is now on the brink of collapse. Record high fossil energy prices today are not a consequence of the power of OPEC or the continuing decline in U.S. oil production, but instead were a consequence of an eminent peak in *global* oil production. The industrial era of economic development of the past 200 years has been fueled by cheap and abundant energy, but the days of cheap and abundant energy are over. Our current conflicts the Middle East are not with a single country, but involve the entire region, including a major military commitment of both troops and money. There can be little doubt that the "strategic interest" of the U.S. in the Middle East is continued access to Middle East oil. At home, a large segment of the manufacturing sector of the U.S. economy has been "exported" to low-wage countries and much of U.S. agriculture is now under control of large *multinational* agribusiness corporations, whose first commitment is to their global stockholders.

No one seems to have a very good estimate of just how much of the so called economic growth of the 2000s is a financial illusion, rather than reality. Today's U.S. economy may well be more illusionary than real. Only after the illusion has been wiped away by the pending recession, or depression, will we know how much of the real American economy is left – the odds are, far less than we have today.

American agriculture is in much the same basic situation as in the 1970s. Ethanol is the main driver of higher prices, but a weak U.S. dollar has also helped keep U.S. farmers competitive in world markets. Once again, government farm programs have remained generous during times of agricultural prosperity, reducing the farmers' risks of overproduction. The government again has encouraged expansion in production through ethanol subsidies and generous farm credit programs. Interest rates are low in relation to inflation, meaning that credit has been affordable and easily available. Since land prices are at new record highs, farmers have been encouraged to use their land as collateral for loans to expand production or invest in cooperatively owned

ethanol and biodiesel plants. No one can foretell the future with certainty, but American agriculture seems to be poised on the brink of another farm financial crisis.

So what can farmers do to survive, if not prosper, during a new farm financial crisis. The world is always changing, but farmers may gain some valuable insights from the farmers who survived the farm crisis of the 1980s. First, the answer is not to do what farmers are been advised to do for the past 50 years. This not the time to get bigger or enter into a corporate contractual arrangement to reduce risks, and they need not get out of farming. The farmers who bought more land and equipment to expand during the 1970s were the ones with the biggest problems during the 1980s. This is not the time to be buying more farmland or high-priced farm equipment. With regard to corporate contractual arrangements, such as those used in concentrated animal feeding operation or CAFOs, these corporations do not make legally binding, long term commitments to their contractors. When times get tough, contract producers are going to be caught with large investments in facilitates and equipment with no animals to feed and thus no means of making their loan payments.

The farmers who survived the farm financial crisis of the 1980s were those who didn't borrow a lot of money during 1970s and who remained diversified, producing several different crops or both crops and livestock, rather than specializing in one or two commodities. Those without large debts obviously were not committed to large loan repayments nor were they subject to bankruptcy, even after significant year-to-year losses. Their equity, primarily in the unencumbered value of their land, was more than adequate to pay off their modest debts. Those who had a variety of crops to sell, or could feed their grain to livestock, were in a better position to manage the risks of losses. Even though prices in general were depressed, different commodities were more or less profitable at different times.

These same strategies are quite logical for the upcoming farm crisis. Those who have bought high priced farmland or invested in ethanol plants may want to seriously consider taking their profits or limiting their losses, while there are still willing buyers. Investments in farmland seem far more risky today than when corn futures prices were at $7.00 a bushel. The optimism and public support for ethanol may be far less with the economy in recession and energy demand in a slump, than when oil prices seemed destined for a $200 per barrel. Minimizing debts and diversification will not necessarily prevent significant losses during times of depressed prices, but such strategies at least increase the odds of survival.

Crises are times of grave risks but also times of great opportunity. The next financial crisis may well be a time of opportunity, particularly for those on small farms. The key to farm financial success in the future will be to manage *intensively*. Conventional commodity producers are *extensive* farm managers. They make more money by managing more acres of land, more hired workers, and more capital, more *efficiently*. They spread their management expertise across more land, labor, and capital. That's why they need to borrow large amounts of money and rent land they can't afford to own. Their profit margins are small but they have large amounts of commodities to sell. However, relatively small increases in costs or small reductions in prices can have a major impact on the economic bottom line of large farming operations.

In addition, a high portion of the costs of large farming operations tend to be for purchased inputs or other out-of-pocket or cash commitments. As one farmer put it recently, "they buy the crop" from the seed dealers, fertilizer and pesticide suppliers, equipment manufactures, and oil companies. As a result, they are not in a position to take less from the business for themselves during hard times; they have to pay their bills. And when large-scale commodity producers are unable to borrow money to cover production costs, they have to cut production. Even if their profit margins remain positive, they have relatively less to sell to make loan payments and keep the business afloat.

Successful small farmers are *intensive* farm managers. They make more money by managing less land, less labor, and capital more *effectively*. Efficiency is about doing things right while effectiveness is about doing the right things. Intensive managers concentrate their management expertise on less land, labor, and capital. Their continuing success doesn't depend on their ability to continually borrow money to buy more land or rent more land that they can't afford to own. Since they have less to sell, their profit margins have to be higher. This means their costs have to be less, their prices higher, or preferably, both.

If they are producers of basic commodities their costs have to be less, which is difficult to achieve on a small farm. In the past, commodity producers with small farms have simply accepted a smaller return for their land, labor, and management. Since they put more management and labor into each bushel or pound sold, they are able to take less out, at least during hard times. They spend less for seed, fertilizer, pesticides, and fuel by relying more on their management of diverse farming systems to maintain soil fertility and control pests. While being able to take less out increases the odds of survival during times of crisis, it is not the key to long run prosperity.

The key to future prosperity, in good times and bad, will be to get higher prices while reducing costs of production. This was not a possibility for farmers in the 1980s because there were no markets for anything other than agricultural commodities, and all basic commodities of the same quality are worth the same price. However, a variety of new market opportunities have emerged since the 1980s in response to growing environmental and social concerns associated with large-scale industrial agriculture. The market for organic foods has been growing at a rate of close to 20% per year for the past 20 years, doubling every three to four years. Retail sales of organic foods are approaching $20 billion per year. This growing preference for organic is not simply a reflection of consumers trying to avoid pesticide and agrichemical residues in their foods. They are concerned about a wide range of issues, including the impacts of their food choices on farmers, farm workers, and stewardship of land and water resources.

Local foods have replaced organics as the most dynamic sector of the retail food market. Recent surveys indicate that around three-fourths of American consumers have a strong preference for locally grown foods preferably grown on small family farms. Retail sales of locally grown foods, now estimated at $4 billion, have increased dramatically in the past decade. Consumers increasingly want to know where their food comes from, how it is produced, and who produced it. Many Americans have simply lost confidence in the integrity of the corporations and the government agencies with whom the integrity of the food system has been entrusted. Increasingly, they are buying food they can trust by buying it from people they trust.

A variety of sources indicate that those who are searching for local alternative to today's industrial foods make up at least a quarter and possibly a third of American consumers, and their numbers are growing rapidly. Over the long run, the potential for this new market is unlimited; it could literally transform the concept of what it means to eat well in America. This new organic-local-sustainable food movement, at its very core, is being driven by concerns for food security – food safety, accessibility, affordability – and these concerns will become even stronger in the times of crisis ahead.

People tend to think of local foods as a niche that is limited to farmers markets and community supported agriculture associations (CSAs), but it is far larger. It is spreading into mainstream food markets, restaurants, schools, and other institutional markets. Eating well is becoming more affordable as more people relearn how to prepare their own food from scratch, rather than buying highly processed, prepared foods. This new market requires *intensive* management but it commands premium prices from discriminating consumers. It is the American farmer's best hope for the future in good times and bad.

Perhaps even more important to survival and success during the difficult times are the relationships created between farmers and their customers. Sustainable, community-based food systems link sustainable farmers with like-minded members of their local communities. Raw or minimally processed foods marketed to local customers not only save their customers money during hard times but also save much of the fossil energy use and environmental pollution associated with industrial food processing, packaging, storage, and transportation.

Farmers markets and community supported agriculture associations (CSAs) provide opportunities to bring local farmers and community members together through their common interests in sustainably produced food. Organizations such Slow Food and the Chefs Collaborative are helping to promote the new “locavore” movement, which encourages people to eat food grown as close as possible to their home. Locavores promote economic viability by providing markets where local farmers can earn enough money to take care of the land and to participate fully in the economic and social life of the community. The sustainable, local food movement is not just about creating new markets it's about developing lasting relationships among people.

Another lesson of the farm financial crisis of the 1980s is that those who fared best had strong personal relationships within their families and communities. Farmers who have developed personal relationships with their customers, who also happen to be their neighbors, will not only have their moral support during the hard times ahead but will have their continuing financial support as well. Friends don't abandon friends when the going gets tough, they stick it out together. Those who eat locally won't go hungry and those who market locally won't go broke. Instead, they will find ways to work though their problems together and their relationships will grow stronger as a consequence.

So, the most important strategy for surviving the next farm financial crisis may be to get to know your neighbors and turn them into customers as well as friends. Wendell Berry writes that farmers of the future “must tend farms they know and love, farms small enough to know and

love, using tools and methods that they know and love, in the company of neighbors that they know and love" – and one might add, producing food for people they know and love. Successful farms of the future will be smaller farms because a person can only truly know and love so much land and know and love so many people. The key to surviving the next farm financial crisis will be a deep and abiding love of land and people.

End Notes

[1] USDA, National Agricultural Statistical Service, *Agricultural Prices*, September 29, 2008, http://usda.mannlib.cornell.edu/usda/current/AgriPric/AgriPric-09-29-2008.pdf

[2]USDA, National Agricultural Statistical Service, *Land Values and Cash Rents, 2008 Summary*, August 2008. http://usda.mannlib.cornell.edu/usda/current/AgriLandVa/AgriLandVa-08-04-2008.pdf