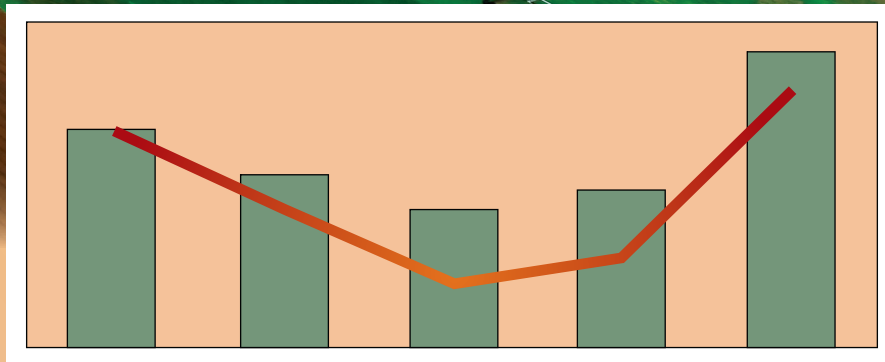
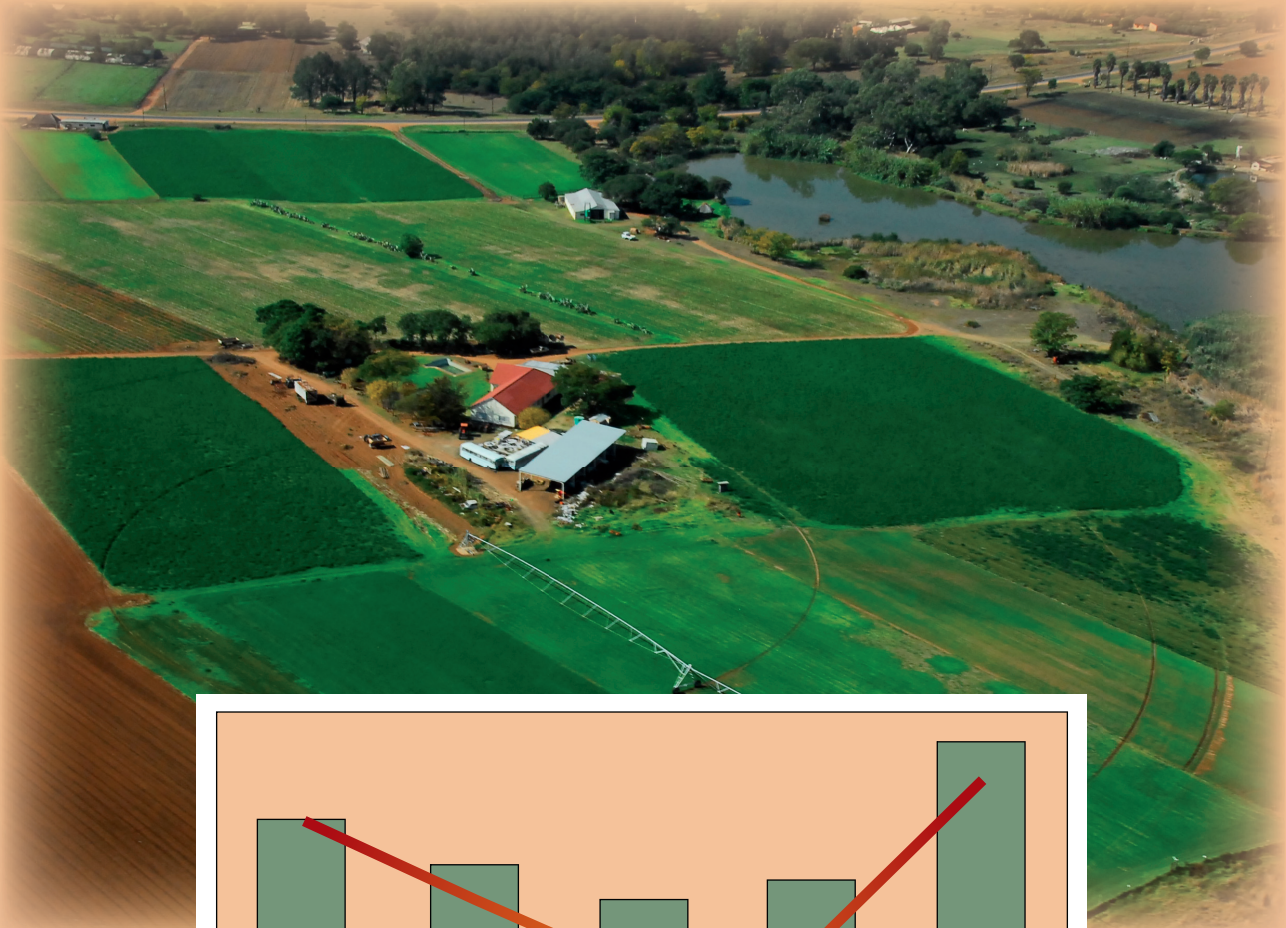


Increasing farm debt amid decreasing interest rates: An explanation



**Compiled by
Economic Research Division**

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EXECUTIVE SUMMARY

In November 2010, the South African Reserve Bank reduced the repo rate and the prime rate to 5,5% and 9,0% respectively, from 12,0% and 15,5% in June 2008. Farm debt continues to increase at a high rate due to the fact that it is not interest rate driven but rather demand driven. This study aims to explain this. The main objective of the study is therefore to identify and discuss factors that contribute to the increasing farm debt amid the decreasing interest rates.

Some of the findings of the study are:

1. Rising inflation rates affect expenditure on inputs and push production costs up. When the prices of farm inputs increase, while the prices of farm products remain constant, farmers suffer from squeezed profits and are thus required to source loans to finance the production activities of the next season.
2. Increase in investment in the agriculture sector amid the squeezed net farm income might translate into increased use of credit to finance farming investments, and this might contribute to increasing farm debt.
3. The continuing high interest rate charged to farmers due to bad credit profile or due to defaults on existing loans contributes to the continuing increase in farm debt.
4. Lower interest rates might encourage farmers to take more loans because they qualify for bigger ones, which would also contribute to the increasing farm debt.
5. The exchange rate has an indirect impact on farm debt through the direct impact it exerts on the cost of farm inputs, particularly the imported inputs.

It is therefore most likely that a combination of factors such as high inflation of farm inputs, increased agricultural investments, high interest rates charged to farmers due to bad credit profile or defaults on existing loans and exchange rate are behind the increasing farm debt.

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1. Introduction

Financial institutions in SA, through the Financial Services Charter, have pledged to increase their support for the development of agriculture in the country. They have committed themselves to increasing their lending in the agricultural sector through envisaged institutional arrangements with the government.

The Land Bank of South Africa is a development finance institution whose mandate is to support, promote and facilitate the development and transformation of the agricultural sector through the Land Bank Act. The Land Bank was established to promote rural and agricultural development. Commercial banks and agricultural cooperatives also play an important role in supporting agricultural developments through financial assistance to farmers.

These financial institutions have a wide and growing range of products and financial services for commercial as well as developing, large-scale and small-scale farmers and the agricultural business sector. These include mortgage loans to well-established commercial farmers or agri-businesses that own fixed agricultural property and want to buy land, consolidate their debts or use it for other purposes linked to agriculture.

They offer long-term mortgage loans, which are fixed instalment loans, for capital expenditure. The duration of long-term mortgage loans and repayment is negotiable – usually between five and 15 years. Medium-term loans in the form of cash credit accounts are

negotiable and are usually paid back over a period of three to eight years. Short-term loans are structured to meet important short-term financial needs in agricultural production. The duration of short-term loans is linked to the season and they are usually paid back over a maximum of 18 months.

The cost of loans acquired from these financial services providers is in a form of interest that is charged at various rates. High interest rates are expected to increase the direct costs of production loan for use in the operations and raise the interest cost for land under variable rate mortgages. This effect is felt by all borrowers. Again, high interests become part of production inputs purchased by farmers.

Increases in the interest rates translate into greater financial burden for farmers who hold variable-rate loans. Higher interest expenses resulting from high interest rates reduce profitability of farms and discourage investment.

In November 2010, the South African Reserve Bank reduced the repo rate and prime rate to 5,5% and 9,0% respectively, from 12,0% and 15,5% in June 2008. Farm debt continues to increase at a high rate due to the fact that it is not interest rate driven but rather demand driven; for instance, if a farmer needs a particular machine he will borrow finance irrespective of how low or high the interest rates are. This study therefore intends to explain this. The main objective of the study is therefore to identify and discuss factors that contribute to the increasing farm debt amid the decreasing interest rates.

2. Trends in interest rates and farm debt

Between mid-2007 and late 2008, the South African Reserve Bank (SARB) applied a principle of increasing the interest rates to curb the high rate of inflation, which peaked at 13,7% in August 2008. The repurchase rate was increased from 9,5% in June 2007 and peaked at 12,0% in June 2008. During the same period, the prime overdraft rate was increased from 13,0% and peaked at 15,5% (see Figure 1 below).

The inflation rate decelerated significantly from August 2008, coming back within the limits of the SARB target inflation bracket in late 2009. Because of the decreasing rate of inflation and other economic developments, the SARB started reducing the interest rates from December 2008.

During the period of deceleration in the rate of inflation, South Africa faced negative economic growth, i.e. between the last quarter of 2008 and the second quarter of 2009. Most industries were negatively affected and South Africa lost a significant number of jobs. This, along with the declining rate of inflation, prompted the SARB to continue reducing the interest rates. In November 2010, the SARB reduced the repo rate to 5,5% reasoning that the outlook for domestic inflation had improved while the economy is still struggling and the Rand remained strong, subsequently the prime rate was reduced to 9,0% (see Figure 1). Between 2008 and 2009, the prime rate declined by 22,6%, while the repurchase rate declined by 28,3%.

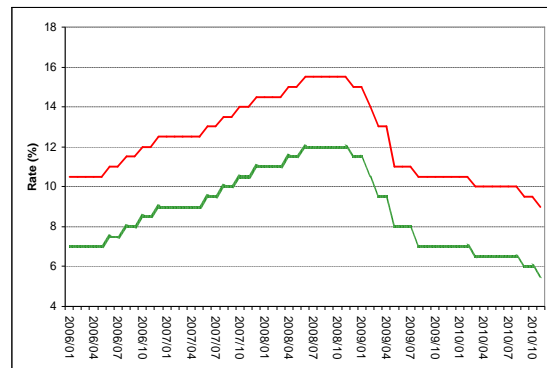


Figure 1: Trends in the prime interest rate between 1999 and 2010

Source: SARB

On the other hand, Figure 2 shows that farm debt continued to increase since 2004. The level of farm debt was estimated at R54,35 billion in June 2010 from R52,0 billion and R31,83 billion in December 2009 and June 2004 respectively. From Figure 2, it is clear that farm debt has been increasing since June 2004 and that it has not decreased at any point except between December 2008 and June 2009 when it decreased slightly by 0,54%. Following this slight decrease, farm debt increased at its highest rate (11,13%) between June 2009 and December 2009 and again by 4,51% between December 2009 and June 2010.

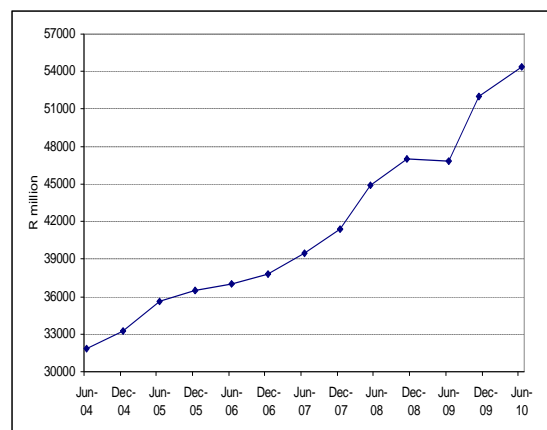


Figure 2: Trends in the farm debt between June 2004 and June 2010

Source: DAFF

3. Factors contributing to increasing farm debt

3.1 Inflation

Rising inflation rate affects expenditure on inputs and thus pushes production costs up. When output prices rise while input prices remain constant, farm profit levels will increase proportionately depending on the rate of change of output prices. When the prices of farm inputs increase, while the prices of farm products are constant, the farmer will suffer from squeezed profits and may have to source loans to finance the production activities of the next season.

Between 2007 and 2008, the prices of most variable agricultural inputs, particularly fertilisers, increased sharply (see Figure 3 below). Figure 4 also shows that fuel costs likewise increased sharply from late 2007 and peaked in mid-2008. However, by early 2009 it reached a level comparable to the level before the increases.

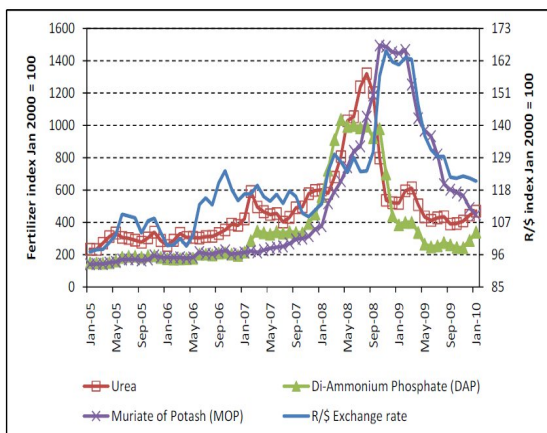


Figure 3: Trends in the selected fertiliser cost and exchange rate between 2005 and 2010
Source: NAMC

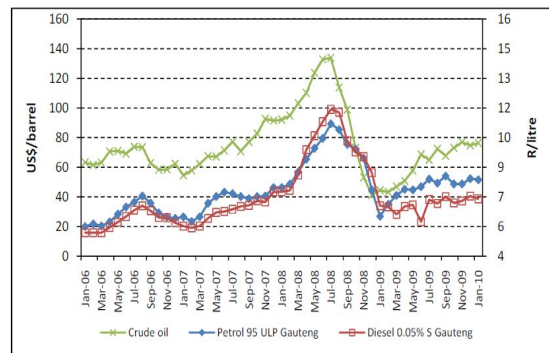


Figure 4: Trends in the prices of fuel between 2005 and 2010

Source: NAMC

Figure 5 shows that between 2007 and 2008, prices of farming requisites increased significantly, with prices of intermediate goods and prices of all farming requisites increasing by almost 35%. Prices of machinery and implements increased by over 15% between 2008 and 2009.

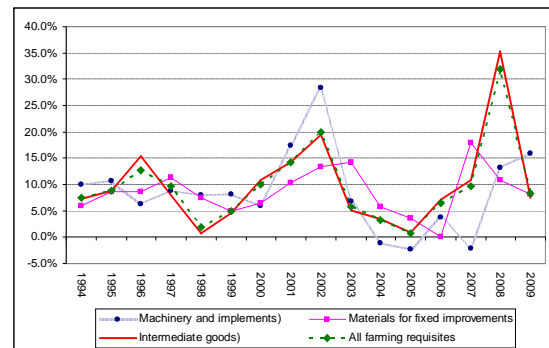


Figure 5: Trends in the inflation of prices of farming requisites

Source: DAFF

From Figure 5 it is clear that the prices of agricultural inputs continued to increase at a rate over 6% between 2008 and 2009. Along with the increase in the prices of farming requisites, the agricultural commodity prices have decreased and this resulted in the net farm income being squeezed by 13% between 2008/2009 and 2009/2010, and by 14% between 2008 and 2009. Some farmers were therefore in a financial crisis and ended up

defaulting on their loans. For example, loan defaults at the Land Bank by emerging farmers are speculated to be at R1,2 billion, while the interest payments by the sector increased by 15,0% for the year ended March 2009. The continuing increase in farm debt is likely to result from, among other factors, loan defaults following the squeezed net farm incomes.

3.2 Investment in agriculture

Tractors, combines and other self-propelled equipment capable of offering new technology features supporting improved performance and precision farming systems are increasingly in demand to satisfy the production and productivity needs of customers. The demand for basic specification tractors and equipment has increased in volume over the past three years and these remain an important and significant segment of the mechanisation business in the South African market.

In 2008, investments channeled towards machinery and implements increased sharply as farmers tried to invest in cost-saving machinery and equipment. Following the 2008 boom in demand for agricultural machinery, which resulted in significant long-term supply, production response to orders for most equipment has improved satisfactorily since April 2009. Figure 6 and Figure 7 show that 2008 experienced the highest sales of tractors and combine harvesters since 1986. Tractor sales for 2008 were 44% up in 2007, while combine harvesters sales more than doubled between 2007 and 2008. However, the sales for the two types of machinery decreased between 2008 and 2009, while they remain higher in

comparison to sales made in most years between 1986 and 2009.

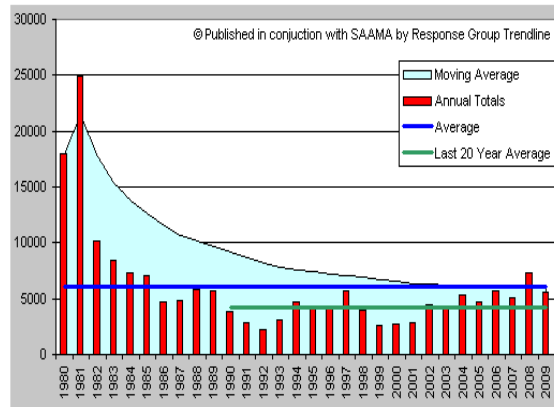


Figure 6: Trend in annual tractor sales between 1980 and 2009

Source: SAAMA

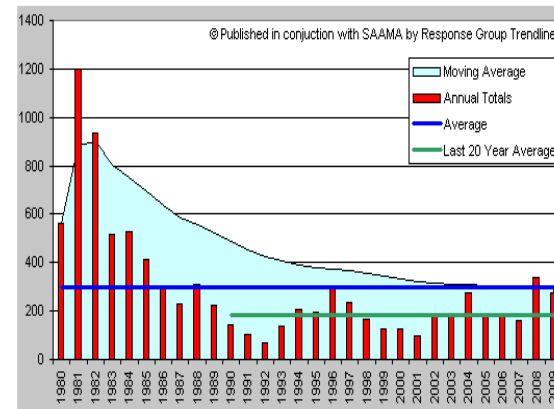


Figure 7: Trend in annual combine harvester sales between 1980 and 2009

Source: SAAMA

The decrease in sales between 2008 and 2009 might be attributed to the global economic slowdown as well as increases in the prices of tractors and other equipments, i.e. a sharp increase of about 45% in November 2008. According to the South African Agricultural Machinery Association, the price increases were influenced by a sudden and significant depreciation of the Rand against the major trading currencies during the same period.

However, prices of tractors and other agricultural equipment progressively decreased in 2009 to approximate pricing levels prior to the sharp weakening of the Rand.

By June 2010, the value of capital assets in agriculture was estimated at R223 434 million, as against R206 582 million in June 2009, an increase of 8,2%. Land and fixed improvements constituted R129 849 million, machinery and implements R41 361 million and livestock R52 225 million of the total value of capital assets. The gross investment in respect of fixed improvements for the year ended June 2010 increased by 1,0% to R3 972 million. In the case of machinery, implements and vehicles, investment decreased by 20,1% and amounted to R6 501 million. The livestock inventory rose by R38,6 million compared to the previous year (DAFF, 2010).

These increases in agricultural investments amid the squeezed net farm income might translate into increased use of credit to finance farming investments. The increased investment might therefore have contributed to the increased farm debt amid the decreasing interest rates.

3.3 Interest rates

According to Monke and Pearson (1989), the interest rate is the price paid for the use of capital and an important macro-price determining accessibility to farm credit. It is an instrument for credit and monetary control used by the national monetary authorities to regulate the level of macro-economic activity in the country. It is also used to regulate the level of money supply which influences a large num-

ber of other phenomena, including the inflation rate.

Although Figure 1 shows that the SARB significantly reduced the interest rate between 2008 and 2009, Figure 8 below shows that, on average, interest rates charged to the farmers continued to increase during the same period. The average interest rate charged to farmers increased by 8,3% to reach 15,6% in 2009, from 14,4% in 2008, due to the fact that most farmers were affected by the financial crisis and ended up defaulting on their loans. The increase during this period follows the two subsequent increases of 13,3% and 14,1% from 2006 to 2007 and from 2007 to 2008 respectively. Therefore, it is highly likely that the continuing increase in the interest rates charged to farmers contributes to the continuing increase in farm debt.

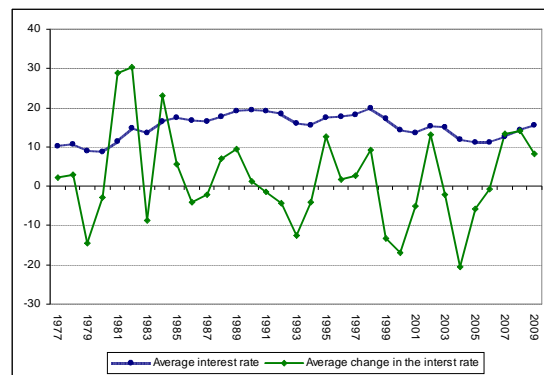


Figure 8: Trends in the average interest rate charged to the farmers and year-on-year change in the average interest rate charged to the farmers

Source: DAFF

3.4 Exchange rate

According to Monke and Pearson (1989), the foreign exchange rate plays a very important role in the importation of inputs and in the exportation of agricultural products where surplus is sizeable. It has an important influence

on farm profitability which, in turn, affects the decision to invest. Depreciation of the Rand against the US dollar has a negative impact on farmers as it will be expensive for them to buy farming equipment and materials from overseas markets.

Exchange rates have an indirect impact on farm debt through the direct impact it exerts on the cost of farm inputs, particularly the imported inputs. For example, Figure 2 in section 3.1 shows the direct relationship between the exchange rate and the cost of fertilisers, which both increased sharply in 2008. Other farm inputs, e.g. machinery and chemicals, are imported and their prices are directly influenced by the exchange rate. The sharp devaluing of the Rand in 2008 might have contributed to the continuing increases in farm debt.

3.5 Opinions of economists from selected banks¹

Economists from selected banks were requested to give inputs to the explanation of the increasing farm debt amid the reduced interest rates by SARB.

Economists believed that lower interest rates encourage farmers to take more loans because they qualify for bigger ones, which will increase the debt load for individual farmers. Therefore, lower interest rates might have encouraged farmers to take more loans and thus increasing farm debt. Another factor is that farmers at some stage defaulted on their loans

because of financial difficulties, and because of those defaults, farmers had to pay penalties which in turn contributed to the increase in farm debt. The strong Rand was also seen as one factor behind the increasing farm debt.

Economists believe that major factors behind the increasing farm debt are the rising input costs paid by farmers, electricity and energy costs. For example, the costs of producing maize were very high in 2009 compared to commodity prices. Also, the cost of funding is an important factor, because a farmer who is not credit worthy will be charged high interest than the one who is credit worthy, and emerging farmers are the mostly affected. Also, the option by farmers to restructure loans to ease the pressure contributes to the increased farm debt. According to these economists, farm debt is not interest rate driven, but rather demand driven. That is, if a farmer needs a particular machine, he will borrow finance irrespective of the low or high interest rates.

4. Conclusion

This study is an attempt to explain the current situation where farm debt is increasing though the SARB has cut the interest rate to its lowest level in decades. High inflation of farm inputs contributes to an increase in the farm debt by compelling the farmers to take out more loans in order to meet increasing production costs amid low agricultural commodity prices. Investments in agriculture, particularly during times of low net farm incomes, are likely to have been financed through loans. A

¹ Inputs from economists from Absa, Ned bank and Land bank are acknowledged and appreciated.

continuous increase in the interest rate charged to the farmers also might have contributed to the increase in farm debt. The exchange rate is also seen as one of the factors, though its impact on farm debt is indirect through changes in the prices of imported farm inputs. It is, therefore, most likely that a combination of factors such as high inflation of farm inputs, increased agricultural investments and increased interest rates charged to farmers are behind the increasing farm debt.

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