A REVIEW OF AGRICULTURAL CREDIT IN NEW ZEALAND

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Views expressed in Agricultural Economics Research Unit Discussion Papers are those of the author and do not necessarily reflect the views of the Unit or Lincoln College.

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PREFACE

There have been a large number of changes in Government Policies and regulations surrounding the agricultural financial markets in recent years. For this reason Messrs Pryde and Bain have updated their monitoring of the finance sector a short time following their two 1984 reports (Discussion Papers 82 and 86).

The Agricultural Economics Research Unit will continue in this and other areas, to monitor adjustments to policy and their impacts on the Agricultural Sector.

R G Lattimore
DIRECTOR

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The authors would like to thank the individuals, Companies and Government bodies who kindly provided information for this paper.

While public statistics on finance provide some information it is only current comment and individual data from these contributors which can provide an overall appreciation of the state of agricultural credit.

SECTION 1

INTRODUCTION

The following discussion of the agricultural credit market encompasses agriculture in its wider sense. Because most of the available information and data on agricultural credit is concerned with traditional forms of pastoral farming (sheep, beef and dairy) the discussion relates primarily to those sectors. However, the growing importance of other sectors such as horticulture, grain cropping and deer farming is recognised and where possible their credit situation is also considered.

The purpose of the paper is to update previous research by the Agricultural Economics Research Unit into the financing of the agriculture industry. (1)

In the past the agricultural credit situation has been relatively stable. Because of its large contribution to exports, agriculture (pastoral agriculture in particular) received considerable support from Government in the form of policies aimed at maintaining a steady flow of investment. Credit assistance was one of the cornerstones of these policies.

But in 1982 the Government began to change its stance. In the Budget of that year interest payments and certain development expenditure ceased to be tax-deductible where the farm property was sold within 10 years of purchase.

Although this steadied inflation in land prices, long term investors - particularly pastoral farm investors - still enjoyed considerable advantages over investors wishing to borrow capital for diversification into or expansion of enterprises which were capable of better returns on investment. It was not until late 1984 that a wide range of policies were introduced to remove these advantages and promote greater equity between enterprises and industries requiring capital for restructuring or expansion. As a result some of the conclusions reached in Discussion Papers on agricultural and horticultural credit published by the Unit as recently as April and October 1984 (1) have been quickly overtaken by economic events and need updating.

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(1) Pryde, J.G. and Bain, L.B. (1984), The State of Agricultural Credit in New Zealand. A.E.R.U. Discussion Paper No. 82, Lincoln College.

Pryde, J.G. and Bain, L.B. (1984), Financing New Zealand Horticulture. A.E.R.U. Discussion Paper No. 86, Lincoln College.

This paper begins with a background of trends in the New Zealand economy and then in chronological order details recent changes in Government Policy. This is followed by a discussion of the implications of these changes for the financing of agriculture. Finally the present state of the agricultural credit market is discussed and some conclusions are drawn.

The discussion is based on a variety of sources including MAF, Reserve Bank, Treasury, AERU and private economic reports and data. A considerable part of the material was also obtained from personal correspondence and interviews with people directly involved in the finance industry. The views expressed are, of course those of the authors.

SECTION 2

RECENT CHANGES IN GOVERNMENT POLICY AFFECTING THE FINANCING OF THE FARMING SECTOR

2.1 Background

Until the mid 1960's New Zealander's enjoyed a high standard of living relative to other OECD countries based on a profitable trade in agricultural commodities. The efficiency of the agricultural industry and the healthy market for its products led to agriculture supplying over 90 per cent of New Zealand's foreign exchange earnings.

This relatively high standard of living based on agricultural exports allowed New Zealand governments to increase their role in the economy, to finance higher levels of expenditure and to pursue a policy of full employment. An increased share of resources, both government and private were channelled into development of protected local industries and services.

But during the 1960's New Zealand's position began to change. Agricultural commodity prices started what was to be a long-term decline in real terms. This was partly because of increasing protectionism in developed countries but also because of factors such as changes in consumer tastes and more abundant supplies of agricultural commodities generally from around the world. The main symptoms of this decline have been poor terms of trade, a rapidly if belatedly devaluing New Zealand dollar and a lowering of living standards relative to other OECD countries.

It is only in recent years, however, that the decline has been recognised as a long-term one. In the meantime New Zealand pursued policies of Government deficit financing and industry protection based on the assumption that relatively high living standards would be restored through a return to higher agricultural commodity prices. As this failed to eventuate New Zealand's relative standard of living declined to the point where it became one of the lowest among O.E.C.D. countries.

Since the decline in the New Zealand economy has been recognised as more than a short term downturn some effort has been made by the Government to remedy the situation. The result has been the removal of some of the anomalies that encouraged inefficient uses of resources and their replacement by increased competition.

Agriculture has been required to make almost immediate adjustments with tax concessions, SMP's, low cost Rural Bank finance and direct subsidies all being removed or substantially reduced within a two year period.

Two factors have often been cited as the reasons for agriculture requiring heavy subsidies. These are an over-valued exchange rate and the denial of access to inputs at world market prices. While devaluation and the subsequent floating of the New Zealand dollar have resolved the former problem the latter is still very much in evidence.

Although devaluation gave local industry a substantial lift in protection, import licence availability is generally to be increased by only 10 per cent of the local market in 1984/85 and 5 per cent each year thereafter. This long phase-in period, added taxes in the form of import licence tender premiums and no definite timetable for a reduction in global import tariffs will probably result in little, if any, relative fall in the cost of manufactured inputs to agriculture. The labour market is unlikely to be exposed to competition. The proposed Goods and Services Tax may have an adverse effect because farming has a low direct tax contribution but a high level of purchases of goods and services. In these circumstances agriculture may bear the brunt of the restructuring of the New Zealand economy.

2.2 The "Claw-back" Tax Provisions

The 1982 Budget was perhaps the first to acknowledge the distortions that were being caused by selective assistance to agriculture. New tax provisions introduced by this Budget were aimed at combating high rates of inflation in land prices. Although other factors such as low cost lending to agriculture, input subsidies and guaranteed returns through SMP's undoubtedly contributed to the high rate of land inflation, tax concessions which allowed taxable income to be turned into tax-free capital gains were singled out as major contributors.

Legislation was introduced which provided for the recovery of tax deductions previously allowed for interest and farm development expenditure where land was sold within 10 years of purchase. The legislation also limited the amount of farming losses which could be offset against profits in other businesses to $10,000. These losses were often the result of high interest and development expenditures which were then recovered as a tax-free capital gain on the sale of the property.

The effect of the legislation was to restrain the demand for land. Tax-free capital gains could still be made on short-term investment but were usually offset by the loss of previous tax savings.

2.3 Reserve Bank Lending to Producer Boards

Currently seven producer boards hold accounts with the Reserve Bank. Of the seven, the Wool Board has no overdraft facility and three have a small overdraft facility (Milk Board, Poultry Board, and Tobacco Board). The largest borrowers are the Dairy Board with a $750 million loan, the Meat Producers Board with a $439 million overdraft and $496 million loan (30 September 1984) and the Apple and Pear Board with a $34 million overdraft (30 September 1984).

The trend has been for these facilities to be restricted or reduced and the Boards encouraged to borrow from commercial sources. Examples are the removal of the Wool Board's overdraft facility in 1983, the phasing out of the Tobacco Board's facility between 1983 and 1988; and the removal of the Dairy Board's overdraft facility which had exceeded $1,200 million, and its replacement (1 September 1985) with a sub-ordinated loan of $750 million.

The term of the Dairy Board's loan is for a period of 40 years, commencing as from 31 May 1986 at an interest rate of 1 percent. With the granting of the loan the Dairy Board was required to find the

balance of its funding requirements for stock and debtors from trading banks at commercial rates.

An exception to the above trend has been the Meat Board's accounts. From 1983 to 1984 the Reserve Bank overdraft increased from $286 million to $439 million. Then on 30 September 1984 the Government approved the placement of the accumulated deficits in the Sheepmeat and Beef Income Stabilisation Accounts ($496 million) into sub-ordinated loan accounts with the Reserve Bank. The term is for 30 years, interest free for the first 5 years then at the rate of 1 per cent.

The bulk of Reserve Bank lending to Producer Board's has been at the rate of one per cent - to help compensate for export and import substitution incentives given to other sectors. The reductions have therefore had a large impact not only on the availability of funds to agriculture but also on the costs of servicing those funds. Notwithstanding this the amended arrangements still amount to a substantial subsidy.

2.4 Removal of SMP's

The Supplementary Minimum Prices scheme was introduced in 1978 - a supplement to the existing industry stabilisation schemes. With the failure of meat and wool prices to reach the predicted levels payments under the scheme (see Table 1) became a major subsidy to the sheep and beef sector.

The SMP payments further increased an already excessive Budget deficit and attracted threats of greater trade restraints in some markets. Under this pressure the Government announced in June 1984 that the SMP scheme for dairy, sheep and beef producers would be abolished after the 1983/84 season. To help sheep farmers adjust lump sum payments equal to anticipated SMP payments were made to the Meat and Wool Boards for the 1984/85 season.

TABLE 1

Payments to Farmers Under
Supplementary Minimum Prices Scheme ($m)

		1980	1981	1982	1983	1984	1985E
WOOL		0.0	0.0	184.2	176.7	78.8	0.6
MEAT-	Lamb	0.0	0.0	93.9	146.5	213.2	72.0
	Mutton	0.0	0.0	8.7	11.6	48.4	38.0
	Beef	0.0	1.9	53.3	17.6	0.0	0.0
DAIRY		1.9	0.0	0.0	0.0	0.0	0.0

E Agricultural Review Committee estimate of lump sum payments.

SOURCE: Ministry of Agriculture and Fisheries

2.5 Devaluation

In the face of a run on foreign exchange holdings, on 18 July 1984 Government announced a 20 per cent devaluation of the New Zealand dollar. The New Zealand dollar had been overvalued for most of the previous 20 years while the currency was managed under fixed and floating peg systems.

The effect of this overvaluation was to transfer income from exporters (principally farmers) who received less $NZ for the (say) $US their product earned: Government, industries and consumers were able to buy more for their New Zealand dollar when paying for foreign finance, goods and services. While this helped restrain price increases in the short term, in the longer term the rate of inflation continued to increase.

Failure to contain inflation has contributed to a considerable decline in the value of the New Zealand dollar over the past 20 years. The movement in the exchange rate index, which is based on the average value of the New Zealand dollar in relation to a basket of currencies, is shown in Figure 1.

The index in Figure 1 does not reveal the change in value of the $NZ against individual currencies and in particular does not show the substantial decline in relation to the strong currencies of economies such as those of the USA, West Germany and Japan. This is shown in Table 2.

TABLE 2

Fall in the Value of the New Zealand Dollar
from March 1965 to March 1985

As Against:	Exchange Rates as at 29.3.65	29.3.85	Fall (%)
U.S. Dollar	1.378	0.4510	67
Japanese Yen	500	115.79	77
West German D.M.	5.51	1.4604	74
Australian Dollar	1.24	0.6488	48
U.K. Sterling	0.505	0.3848	24

SOURCE: Reserve Bank

The past overvaluation of the New Zealand Dollar affected adversely the financing of agriculture. With the consequent reduction in farm incomes farmers were placed at a disadvantage in competing for finance on the open market. The result was the development of a wide range of Government regulations and subsidies to help agriculture compete.

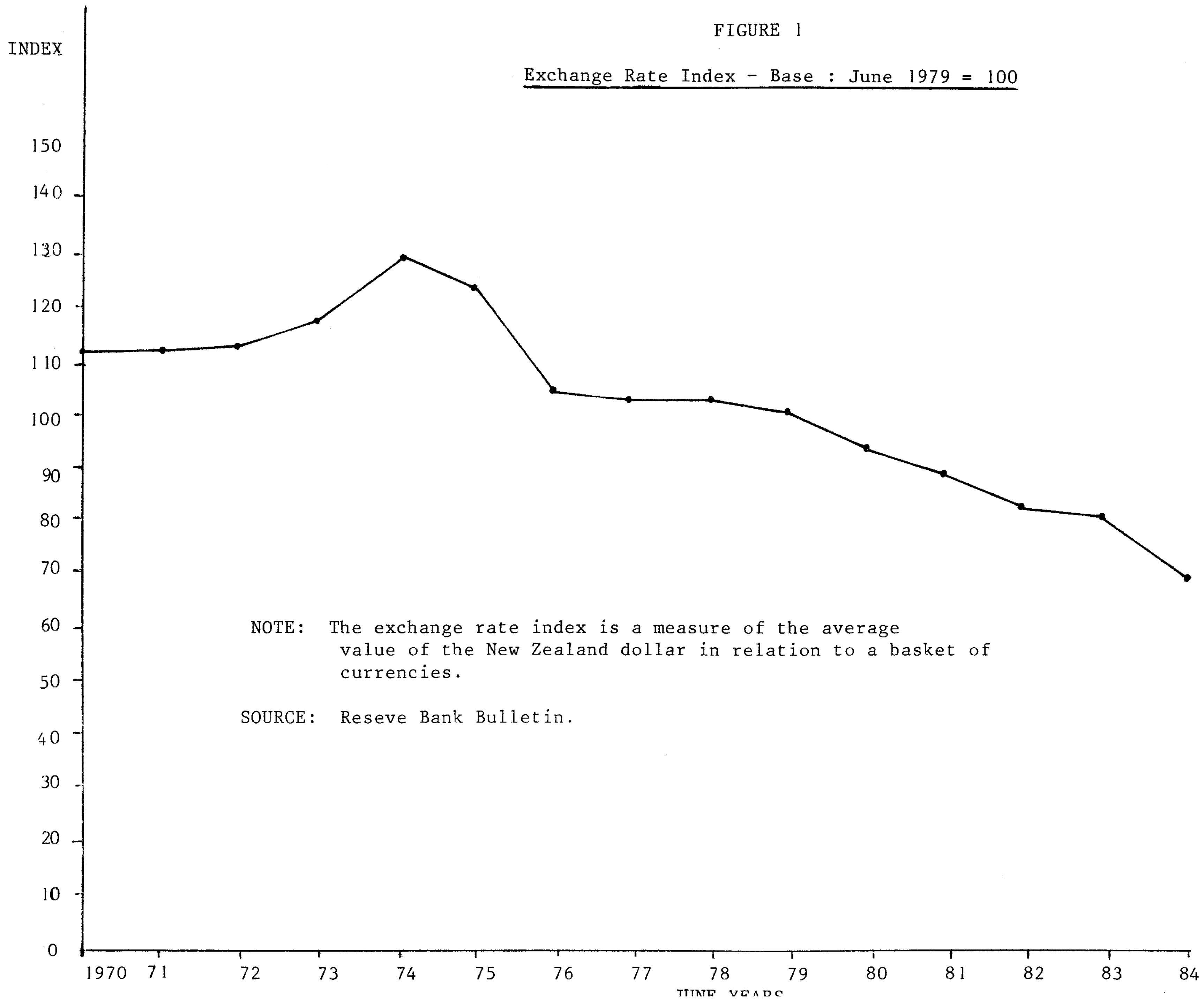


FIGURE 1

Exchange Rate Index - Base : June 1979 = 100

2.6 Decontrol of Interest Rates

In the year leading up to the devaluation in July 1984 a series of new Government regulations had been introduced to try and reduce interest rates comprehensively in line with the falling rate of inflation which had been brought about by the wage and price freeze. Existing regulations controlled only a limited number of financial institutions such as savings banks, trading banks and stock and station agents.

As a result loan funds tended to dry up. The reduced amount available went only to enterprises having the least risk - interest rates could not be increased for higher risk enterprises. This inhibited the development of new enterprises as these tend to have a greater risk factor.

With the announcement of devaluation in July 1984 these recent controls on interest rates were lifted. This allowed most institutional and individual lenders to set their own interest rates both for loans and deposits. Long standing regulations which prevented trading banks paying interest on deposits of less than 30 days and which limited the rate on ordinary savings accounts to 3 per cent were abolished six weeks later.

2.7 Termination of the Wage and Price Freezes

In an effort to reduce the rate of inflation Government regulations were introduced in June 1982 which imposed a wage and price freeze. This freeze with extensions continued until November 1984. The benefit of the freeze to farmers was reflected in the greatly reduced rate of increase in farm costs (Table 3).

TABLE 3

Sheep and Beef Farm Input Prices
- annual percentage change

Year ended 1 Jan	1981	1982	1983	1984	1985E
All Groups Prices	23.0	17.1	10.1	0.3	11.0

E Agricultural Review Committee Estimate

SOURCE: Ministry of Agriculture and Fisheries

Since the termination of the freeze new wage fixing rules have been announced and a tight monetary policy is being pursued to restrain inflationary pressures. Despite these measures the rate of inflation has nearly doubled from a rate of 2.2 per cent for the June 1984 quarter to 4.3 per cent for the March 1985 quarter. Private sector firms recovering their margins following the end of the price freeze were a significant factor but higher costs for imports following devaluation and new methods of setting Government charges for goods and services must also be contributing factors.

2.8 Reductions in Input Subsidies

In 1982 the first moves towards reducing input subsidies began with reductions in fertiliser and weed control subsidies. However, the major reductions were not announced until the 1984 Budget.

This package included the removal of fertiliser transport subsidies from Budget night and the fertiliser price subsidy from 31 March 1986. The cost of product inspection services provided by MAF was put on a cost recovery basis - one third recovery in the 1985/86 season and two thirds recovery in the 1986/87 season. Also subsidies on irrigation schemes were halved and those on water supply schemes were reduced from 50 to 35 per cent. The agricultural investment allowance and payments under the Noxious Plants Control Scheme expired in March and February 1985 respectively.

2.9 Rural Bank Interest Rates

In addition to the reduction in input subsidies the 1984 Budget announced reductions in interest rate subsidies on Rural Bank lending. These had increased steadily since 1974 as Rural Bank interest rates were allowed to fall behind commercial interest rates. The gap and therefore subsidy was increased in 1983 when Rural Bank interest rates were reduced by the Minister of Finance as part of measures to press private sector lenders to reduce interest rates.

The 1984 Budget - measures which also applied to Lands and Survey Department and Maori Affairs Department farm loans - provided for interest rates to be increased in steps up to a market "indicator" rate of 15 per cent. For those loans which were at rates of less than 9.5 per cent the adjustment will take six years to complete.

2.10 Removal of Foreign Exchange Controls

On 21 December 1984 following a substantial increase in foreign exchange dealer licences (now 15) during 1984, the introduction of a more realistic exchange rate and market determined interest rates, foreign exchange controls were abolished. These controls had been in force in one form or another since 1938 and were finally acknowledged to be generally ineffective.

2.11 Removal of Reserve Asset Requirements

On 7 February 1985 regulations which had required private financial institutions to hold specified proportions of their capital in Government and Local Body securities were abolished. Although introduced to give security to investors they had become increasingly a tool of monetary policy. Excess liquidity was absorbed by increasing the reserve asset requirement, thus curbing the ability of institutions to lend. The deposits also came to be used as a source of low-cost public debt. The removal of the controls became possible with the move to higher interest rates on public debt and the use of open market sales to control liquidity.

2.12 Floating of the New Zealand Dollar

The most recent step in reducing controls affecting financial institutions was the change from a fixed to a floating exchange rate on 4 March 1985. As discussed earlier the fixed and floating peg exchange rate systems frequently overvalued the $NZ to the farmers' disadvantage. The new exchange rate system should be a fairer means of remunerating those farmers who sell their products on overseas markets.

SECTION 3

IMPLICATIONS OF THESE CHANGES FOR THE FINANCING OF AGRICULTURE

3.1 Servicing Ability

3.1.1 Incomes

The impact of recent changes in Government policy varies with the sector of agriculture being considered. Generally incomes have improved since devaluation as prices for inputs remained frozen for three months while prices for agricultural products showed almost immediate improvements.

But now the adverse effects of devaluation and the ending of the price freeze, interest rate decontrol and the removal of subsidies are beginning to be reflected in current farm incomes and particularly in farm budget projections.

In the horticulture sector there are wide variations. Nectarine and apple growers have had a particularly good year and kiwifruit returns have picked up since the 1983 downturn. But crops such as squash, onions and potatoes have shown very poor returns.

Grape growers have also experienced falling returns as wine consumption has failed to keep up with the increase in production. This problem has been compounded by a lift in the tax on wine by approximately $1 per litre and increased imports from Australia under the CER agreement.

Overall the pastoral sector appears to have experienced a significant improvement in incomes during the 1984/85 season. Factory supply dairy farm incomes may be an exception. Assuming little change in the prices paid to farmers and a normal 1984-85 season, net incomes are estimated to decline by 8.4 per cent on incomes received in 1983/84 which was a particularly good production season.

By contrast 1984/85 sheep and beef farm incomes are expected to increase by 44 per cent over the 1983/84 financial year. This is a result of a combination of particularly poor returns in 1983/84, a good production season in 1984/85 and the improvement in prices following devaluation.

This improvement in incomes will undoubtedly help sheep and beef farmers to cope with the increases in the cost of finance which occurred in 1984. There has been such an improvement that farmers are repaying some of the seasonal debt which was incurred to maintain working capital during the poor 1982/1983 and 1983/1984 seasons. This is reflected in the subtantial fall in the amount of seasonal borrowing from Stock and Station Agents and Trading Banks.

However, this improvement in most pastoral incomes in the 1984/85 season creates a false impression. The benefits of devaluation and the good season will soon be more than offset as the average interest rate increases as loans come up for review or renewal. The negative impact of devaluation in the form of rising input costs and the effect of removing subsidies will combine to depress farm incomes

even further. In total these changes are estimated to result in an 18 percent (MWBES 1985) fall in farm incomes during the 1985/86 financial year.

Farmers' outlook for agricultural prices which usually tends to be optimistic showed some pessimism in the results from a recent survey of farmer opinion (Pryde and McCartin, 1985). These results are shown in Table 9. When combined with declining incomes this uncertainty about the future is tending to discourage farmers from further borrowing. But there are of course always those who spend all their cash income and expect to borrow their way out if there is a downturn. In this coming downturn they are likely to find that they cannot afford to borrow more. By contrast the efficient farmers are conserving their cash through income equalisation deposits, repaying short-term debt or building up cash deposits with financial institutions in readiness for the 1985/86 financial year.

3.1.2 Cost of Finance

The cost of finance to farmers is very variable. On average the cheapest sources have been Local Bodies and the most expensive have been Finance companies. Overall the average interest rate paid by farmers has been relatively low (Table 4) as those sources contributing the most finance to agriculture have had the lower interest rates.

TABLE 4

Interest Rates Paid by Farmers
(as at June 1984)

Source	Minimum	Maximum	Mean
Rural Bank	3	19.5	8.8
Other Govt.	5	24.0	9.8
Trustee Banks	7	22.0	14.6
Trading Banks	4	22.0	14.7
Building Societies	11	19.0	15.2
Insurance Companies	7	23.5	14.2
Stock & Station Agents	5	21.0	15.3
Trust Companies	8	20.0	15.2
Solicitors Trust Funds	9	20.0	16.5
Family Loans	0	24.0	9.9
Vendor Finance	0	25.0	12.7
Local Body	3	15.0	8.3
Finance Companies	0	25.0	17.9
Dairy Companies	3	18.0	13.8
Private Savings Banks	14	19.0	16.5
Other Sources	0	22.0	12.9
Overall	0	25.0	11.8

SOURCE: Derived from unpublished data from the Lincoln College "New Zealand Farmer Intentions and Opinions Survey, 1984".

Following the removal of controls on interest rates with the devaluation in July 1984 interest rates on new lending increased quickly to rates on a par with those charged before the controls were introduced (Table 5).

TABLE 5

New Mortgage Interest Rates
- Private Sector Sources

Month	1983 May	1984 May	June	July	Aug	Sept	Oct	Nov	Dec E
Av.Rate %	17.27	12.86	12.93	12.76	13.08	13.91	15.01	16.01	17.00

E Estimate

SOURCE: Reserve Bank Bulletin

Interest rates on existing loans have been slower to impact on farm incomes. Up until the time of the removal of controls interest rates were still being reduced at loan reviews. It was often the case that these lower rates came into effect after the removal of controls and could not be increased again until the next review. Even with the modern trend to short review periods of less than one year it is unlikely that the average rate of interest on existing loans will return to pre-control levels until the 1985/86 financial year. Thus it will not be until the end of the 1985/86 year that the full impact of removing the controls will be seen in farmers' financial records and the national statistics based on them.

One steadying influence on the rising cost of finance to farmers has been the move to small stepped increases in Rural Bank interest rates. The effect of this policy has been considerable as Rural Bank loans account for more than one third of all farm debt (Table 11). Not only are the interest rate rises in smaller steps, but the increases are delayed considerably more than is the case with private sector loans. Rural Bank interest rate reviews are much further apart - typically one year as compared with 3 months or less for loans from the private sector.

An important aspect of higher interest rates is the increasing financial leverage of farmers. Traditionally farmers have a low debt to equity ratio in order to maintain their security through adverse seasons. Results from the 1983 Meat and Wool Boards' Economic Service survey of sheep and beef farmers reveal that 50 per cent have 84 per cent equity or better. Despite this many farmers have a cash flow problem and nearly 40 per cent are spending at least 20 per cent of their gross earnings on interest alone (Taylor, 1985).

Although the average debt to equity ratio improved during the 1980-82 boom in farmland prices, security has declined since 1980. This is partly the result of a small subsequent decline in equity but primarily it is because farmers' financial leverage - in terms of their debt servicing to income ratios - has increased significantly since 1980 (Table 6).

TABLE 6

Interest as a Percentage of Gross Farm Income
(Sheep and Beef Farms)

Year	1977/78	1978/79	1979/80	1980/81	1981/82	1982/83	1983/84E	1984/85E	1985/86E
%	10.2	9.5	9.5	10.7	12.7	13.3	12.4	11.4	14.0

E Estimates

Source: Meat and Wool Boards' Economic Service

Associated with this increase in leverage is the increase in interest costs as a percentage of total farm expenditure (Table 7). This affects farmers' flexibility as the cost cannot generally be reduced in poor seasons as can be done with most other farm expenses.

TABLE 7

Interest as a Percentage of Total Farm Expenditure
(Sheep and Beef Farms)

Year	1977/78	1978/79	1979/80	1980/81	1981/82	1982/83	1983/84E	1984/85E	1985/86E
%	14%	14%	14%	14.6%	16.3%	18%	15.4%	14.8%	17.7%

E Estimates

Source: Meat and Wool Boards' Economic Service

In both Tables 6 and 7 the effect of interest rate controls and the Government directed reduction in Rural Bank interest rates can be seen in the fall in the ratios in the 1983/84 year. The fall is repeated in the 1984/85 financial year because of a substantial increase in gross income and in total expenditure as farmers increased their expenditure in line with their higher income.

In 1985/86 the upward trend in financial leverage is estimated to resume with the ratios returning to the levels existing before the introduction of general interest rate controls and the devaluation. Unless there is a substantial improvement in meat and wool prices farmers financial leverage should increase above the previous highs as higher interest rates are applied to a greater proportion of farm loans.

Farmers, both in horticulture and agriculture, who borrow most of their funds from private financial institutions were the first to bear the cost of the removal of Government subsidies. Following deregulation in July 1984 private sector interest rates at loan reviews rose steadily from the regulated 11 and 14 per cent to the current levels of 18-22 per cent.

Higher interest rates were not introduced by Government institutions lending to the rural sector until after the Budget of November 1984. Not only was the introduction of interest rate increases delayed in the case of those institutions but the increases are programmed in steps rather than applied immediately.

On the surface this appears to give farmers borrowing from the Government insitutions an easier adjustment to the removal of subsidies. However, many clients of the Rural Bank, Lands and Survey Department and the Department of Maori Affairs have been assisted onto their farms with much lower equity than would be prudent for private sector borrowers. This was feasible only because of the low interest rates which were offered. The consequent high level of debt results, even at subsidised interest rates, in interest payments accounting for a large proportion of their farm costs. Although on average their interest rate increases are smaller, the increase in their total interest payments is likely to be more substantial than for clients of the private institutions.

3.2 Availability of Funds

The biggest change in the financing of agriculture in the last twelve months has been in the availability of finance. While interest rate controls were imposed, farm credit, in particular term and mortgage finance, was very difficult to obtain for all except borrowers offering prime security. Now finance is much more readily obtainable from traditional private institutional lenders (particularly medium-term finance) and even Rural Bank finance is less scarce.

Freeing of interest rates has contributed to this change by curbing the growth in demand from farmers. It has also encouraged more deposits back into the institutions. Devaluation has also contributed to the improvement in the availability of finance. The consequent reduction in the exchange risk attracted more funds into New Zealand. These funds have arrived as deposits with financial institutions and increasingly as direct loans to New Zealand companies and farmers. With less need for high cost forward cover offshore borrowing has become an attractive option to farmers.

With the exception of off-shore loans there appears to be little likelihood of much improvement in the availability of long-term finance. Most private sector lending is for terms of less than 10 years and the Rural Bank is still by far the major source of long-term finance. Although the Rural Bank has a reasonable supply as a result of the current fall in demand even this source may dry up as more of its funding has to be found on the commercial market.

A further change in the last nine months which will affect the availability of credit to agriculture was the withdrawal of a Reserve Bank directive for some financial institutions to hold a minimum percentage of their investments in agriculture, or alternatively in export industries generally. This had given agriculture some advantage especially while credit was in short supply. In practice not only were funds more readily supplied to agriculture but they tended to be provided at better than average rates.

Agriculture no longer enjoys these privileges and must compete on equal terms with other sectors. Now farmers' ability to attract funds will depend primarily on the security they can offer and their ability to service loans.

The other factor will be the degree of exposure to agriculture which the various institutions are prepared to assume. This may be declining. Farmers are generally recognised as a good risk - in comparison to other small business people they tend to have a greater interest in their asset and will try harder to meet their commitments and hold on to their farm. But now many farmers are facing a significant decline in incomes and in the value of their assets. As a result some financial institutions are concerned and are now reviewing their exposure to the agricultural sector, especially in view of the fact that the industrial sector continues to enjoy a high level of protection enabling it to compete more favourably for funds against agriculture.

3.3 Effect on Farm Investment

The removal of support for agriculture, in particular the support for sheepmeat producers in the form of SMPs and low cost Government loans is beginning to encourage change.

A trend towards greater diversification is already occurring and is likely to accelerate during 1985/86 as farmers more fully appreciate the seriousness of the downturn in sheep farm incomes. The main attractions at present appear to be deer and goat farming but horticulture and forestry are also attracting some interest. Significant moves to diversify may be confined to farmers in a strong financial position as the capital inputs could be too costly to service for those farmers who already have a high degree of financial leverage. In addition to change in the form of diversification there is also change occurring in the type and amount of capital expenditure. The heavy expenditure in recent years on buildings and pasture development is being curtailed and although there has been some increase in development expenditure in 1984/85 this has largely been on consolidating development through improving water supplies and fencing. The increase in capital expenditure in 1984/85 would have also been influenced by extra capital purchases to take advantage of the Agricultural Investment Allowance before its termination on 31 March 1985.

The outlook for 1985/86 is for a 62 per cent fall in capital expenditure for sheep and beef farmers reflecting farmers' need to retrench in the face of declining gross incomes and rising costs. Dairy farmers are expected to cut back capital expenditure by 45 per cent. Although their gross incomes are likely to be maintained the cutbacks are likely to be necessary because of cost increases (Ministry of Agriculture and Fisheries, March 1985).

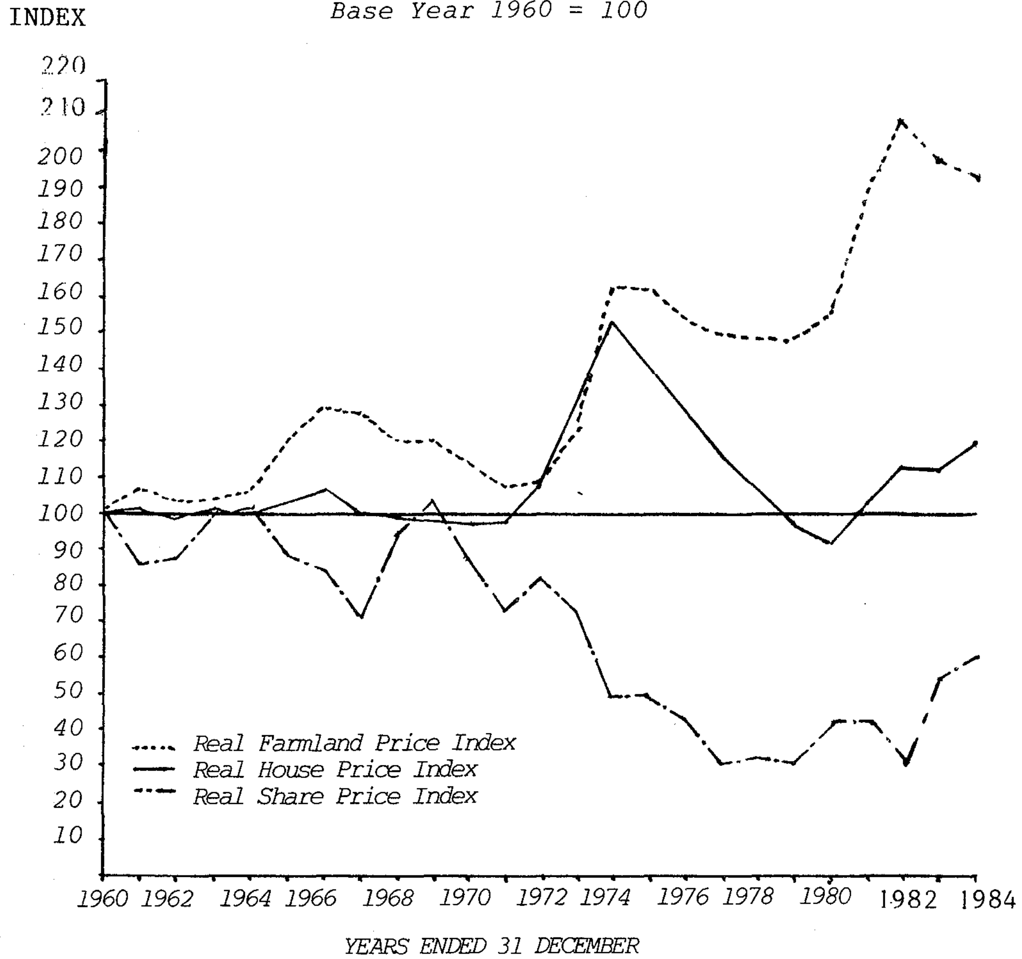
In all sectors of farming the combination of tax changes, removal of subsidies and high market rates of interest is having a very important impact on farmers' largest investment - land. With the change to a "more-market" approach for agriculture farmland has come to be recognised as considerably overvalued in some areas. There are few buyers despite the fact that asking prices are now often below Government valuation. Marginal farmland has been particularly affected by the current review of farmland prices.

This reappraisal of farmland values has been indicated since the early 1970's. Since the land boom of 1972/74 real values of farmland have become increasingly out of step with the real value of other equity investments (Figure 2).

FIGURE 2

Real Price Indices (1960-1984)

Base Year 1960 = 100



SOURCES: *Share Price Index - Reserve Bank Share Price Index*
Farmland Price Index - Valuation Department
Consumer Price Index - (All Groups) Department of Statistics
Report of the Task Force on Tax Reform 1982

The readjustment of land values towards a value which can be supported on the basis of earning capacity began in the 1982/83 financial year (Table 8).

It is almost certain that this downward adjustment has continued and that equity is being squeezed out between falling capital values and rising debts. The 1983/84 year was an exception as the All Farmland Price Index (Valuation Department) recorded an approximate 4 per cent rise in the value of fattening and grazing properties which was not offset by the 11 per cent increase in debt (a smaller base).

The apparent fall since June 1984 in the value of farmland over-all is possibly a reflection of farmers' price expectations and their opinion of the likely movement in costs. In the 1984 Survey of New Zealand Farmer Intentions and Opinions farmers' expectation of inflation for 1984/85 was 13.5 per cent. This view of the inflation rate was not accompanied by a very optimistic outlook on the market prospects for some major agricultural exports (Table 9). As a result farmers' projections of returns from farming must be falling and the value of land is being measured accordingly.

This apparent fall in farmland prices is only just beginning to be reflected in the Valuation Departments' farmland indices. In the half-year ended June 1984 all types of farmland were still showing increases in value and the All Farmland Price Index increased by nearly 4 percent. In the December 1984 half-year grazing and fattening farmland prices showed a renewed decline but dairy, arable and horticultural farmland continued to record increases so that the All Farmland Index still increased by 0.5 per cent.

From Table 10 it can also be seen that overall, farmers equity has not declined significantly since the peak of the land boom in 1982. Although debt increased by 22 per cent between March 1982 and March 1984, this was more than offset by increases in capital value. Why the Valuation Department statistics do not correspond with Real Estate Agents' reports of significant declines in some farmland values is not clear. The delay between sales and the Department receiving sale notices is possibly one factor. Another explanation may be increases in the value of smaller blocks of land used as "lifestyle farms" which could be offsetting the apparent decline in the value of larger economic units.

TABLE 8

Sheep and Beef Farms : Measures of Economic Profitability

(Weighted Average of All Farm Classes)

Year	Capital $	Liabilities $	Equity Capital $	Interest $	(1) Net Farm Income[a] $	(2) Less Assessed Managerial Reward $	(3) Return on Equity Capital[b]	(4) Gain in Equity Capital (Non-tax)	(5) Equivalent to Taxable Return on Equity Capital of: (Taxable Equiv.@ 30% rate)	(6) Total Return on Equity Capital of (3) + (5)
1978	340,991	80,614	260,377	5,070	13,888	9,380	1.7%	6.2%	8.9%	10.6
1979	430,132	90,285	399,847	5,848	19,494	11,452	2.4%	30.4%	43.4%	45.8
1980	558,120	99,267	458,853	7,438	24,772	13,685	2.4%	35.0%	50.0%	52.4
1981	709,156	112,488	596,668	8,964	21,698	16,507	0.9%	30.0%	42.9%	43.8
1982	807,589	137,744	669,845	10,896	21,401	19,431	<0.1%	12.3%	17.6%	17.6
1983	797,426	153,715	643,711	14,782	23,396	19,420	<0.1%	-3.9%	-5.6%	-5.6
1984*				12,900	20,500					
1985*				14,700	29,600					
1986*				16,200	24,400					

* Estimates

NOTES: (a) Net Farm Income has to meet personal living expenses, taxation commitments, capital repayments, the purchase of capital items and any other investments.

(b) Net Income - assessed managerial award.

SOURCE: Compiled from Meat and Wool Boards' Economic Service Survey Data.

TABLE 9

Farmer Opinion on Future Market Prospects for Agricultural Produce

	Optimistic (per cent)	Reasonably Satisfied (per cent)	Pessimistic (per cent)
SHORT TERM			
Sheep Meat	14.5	38.2	47.3
Beef	48.4	43.9	7.7
Wool	41.4	51.6	7.0
Dairy Produce	16.9	49.7	33.4
Horticultural Produce	54.6	39.5	5.9
Deer Industry Produce	51.9	39.0	9.1
Goat Industry Produce	39.5	36.5	24.0
MEDIUM TERM			
Sheep Meat	21.6	47.1	31.3
Beef	35.5	53.9	10.6
Wool	46.0	48.4	5.6
Dairy Produce	16.1	48.4	35.5
Horticultural Produce	45.3	46.3	8.4
Deer Industry Produce	39.6	49.2	11.2
Goat Industry Produce	35.0	44.0	21.0
LONG TERM			
Sheep Meat	37.8	34.0	28.2
Beef	34.3	51.0	14.7
Wool	50.8	42.6	6.6
Dairy Produce	27.5	37.8	34.7
Horticultural Produce	43.8	40.3	15.9
Deer Industry Produce	32.8	45.1	22.1
Goat Industry Produce	34.7	41.3	24.0

Source: Pryde and McCartin (1985): Survey of New Zealand Farmer Intentions and Opinions (Progress result based on 1,543 valid responses)

TABLE 10

FARM CAPITAL AND DEBT

as at 31st March ($m)

Year	Net Equalised Capital Value of Counties [1]	Estimate of Total Farming Capital [2]	Loans Outstanding to the Agricultural Sector [3]	Equity	Equity as a percentage
1978	13,754	17,192	2,362	14,830	86.3
1979	15,219	19,024	2,851	16,173	85.0
1980	17,650	22,062	3,453	18,609	84.4
1981	29,171	36,464	4,196	32,268	88.5
1982	40,892	51,115	5,216	45,899	89.8
1983	45,190	56,488	5,833	50,655	89.7
1984	50,482	63,102	6,481	56,621	89.7

(1) An estimate of the current value of all counties, not just those revalued in the current year, but excluding properties that are not rated e.g. unoccupied crown lands, churches, schools.

(2) Assuming land and buildings accounts for 80% of total farm capital.

(3) Derived from data contained in "Survey of Farmer Intentions and Opinions" (1978–84).

SECTION 4

THE CREDIT MARKET

4.1 Developments in the Financial Sector

4.1.1 General

The Government's moves towards deregulation of the financial sector and of maintaining tight liquidity through a particularly active public debt sales programme has considerably stiffened competition for funds.

There has always been competition for funds but with the removal of interest rate controls the competition is now centred primarily on price rather than on financial services offered or availability of funds for future borrowing by the depositor. Because the higher prices are being paid by all institutions depositors recognise that there will be little likelihood of obtaining significantly cheaper finance in the future from a particular institution and therefore deposits are being made on the basis of current income rather than savings when borrowing in the future.

The margins between borrowing and lending which financial institutions have traditionally been obtaining are also likely to be reduced following deregulation. These margins will be squeezed between the rising cost of funds - as those requiring funds compete against the Government which has a large internal deficit and is maintaining a tight monetary policy - and consumer resistance to 20 per cent plus interest rates.

The removal of reserve asset requirements is unlikely to help the funding situation until the interest rates being paid on current Government stock issues are reduced. Selling low interest bearing stocks to free funds for private sector investments is not really a viable alternative for most institutions because of the capital losses which would be involved.

One move, which is likely to result from increased competition both for funds and in margins is increasing specialisation by institutions in order to make the best use of their funds and expertise and to reduce overheads. This may be particularly so of the finance companies owned by the trading banks. In most cases they were established to overcome the "30 day rule" preventing trading banks from paying interest on deposits of less than one month. With the removal of this rule their original purpose has been lost. Specialisation in some aspect of financing such as discounting, or venture capital funding could give new purpose to these companies.

4.1.2 Farm Financing

An advantage of this increasing competition and specialisation could be a move towards meeting the needs of the Rural Sector with more appropriate finance proposals. Already there has been a considerable move towards providing badly needed long term (greater than 10 year) finance through off-shore borrowing facilities. Many institutions are also starting to recognise the cash flow difficulties of developing agricultural enterprises (especially those with long-term horticultural crops) and providing greater amounts of funding on an interest only

basis.

The deregulation of the finance industry has put the cost of finance back to pre Wage and Price Freeze levels and more, but the higher cost has been offset to some degree by the improved availability of funds particularly to new enterprises capable of showing a high return on investment. Previously investment in these was stifled because funds tended to go to more secure but usually less profitable propositions.

4.2 Total Agricultural Lending and Market Shares

Considering the capital invested in the farming sector total farmer indebtedness is not high. As at March 1984 indebtedness was estimated to have reached $6.7 billion. This compares with an estimated total capital invested of more than $63 billion. The breakdown of this debt between sources of credit is shown in Tables 11 and 12.

Within this total debt there have been considerable changes in the importance of the various institutional sources of agricultural credit. The changes in real terms are illustrated in Figure 3.

4.3 Government Sources

4.3.1 Rural Banking and Finance Corporation

The Rural Bank is by far the largest single lender to agriculture supplying over 30 per cent of total credit used in agriculture. In comparison family loans are the next most important source providing 15 per cent of the credit used. Trading Banks, the largest source of private institutional credit were supplying just 12 per cent of total agriculture credit as at March 1984.

This growth in importance of the Rural Bank occurred mainly in the period 1970-84. During this time inflation quickly raised the cost of private sector borrowing while Rural Bank rates (Table 15) were held at low levels by the Government in order to compensate the agricultural sector for the overvalued exchange rate, the poor terms of trade and the higher cost of farm inputs as a result of industrial protection in New Zealand. On many units the low Rural Bank rates made further investment economic.

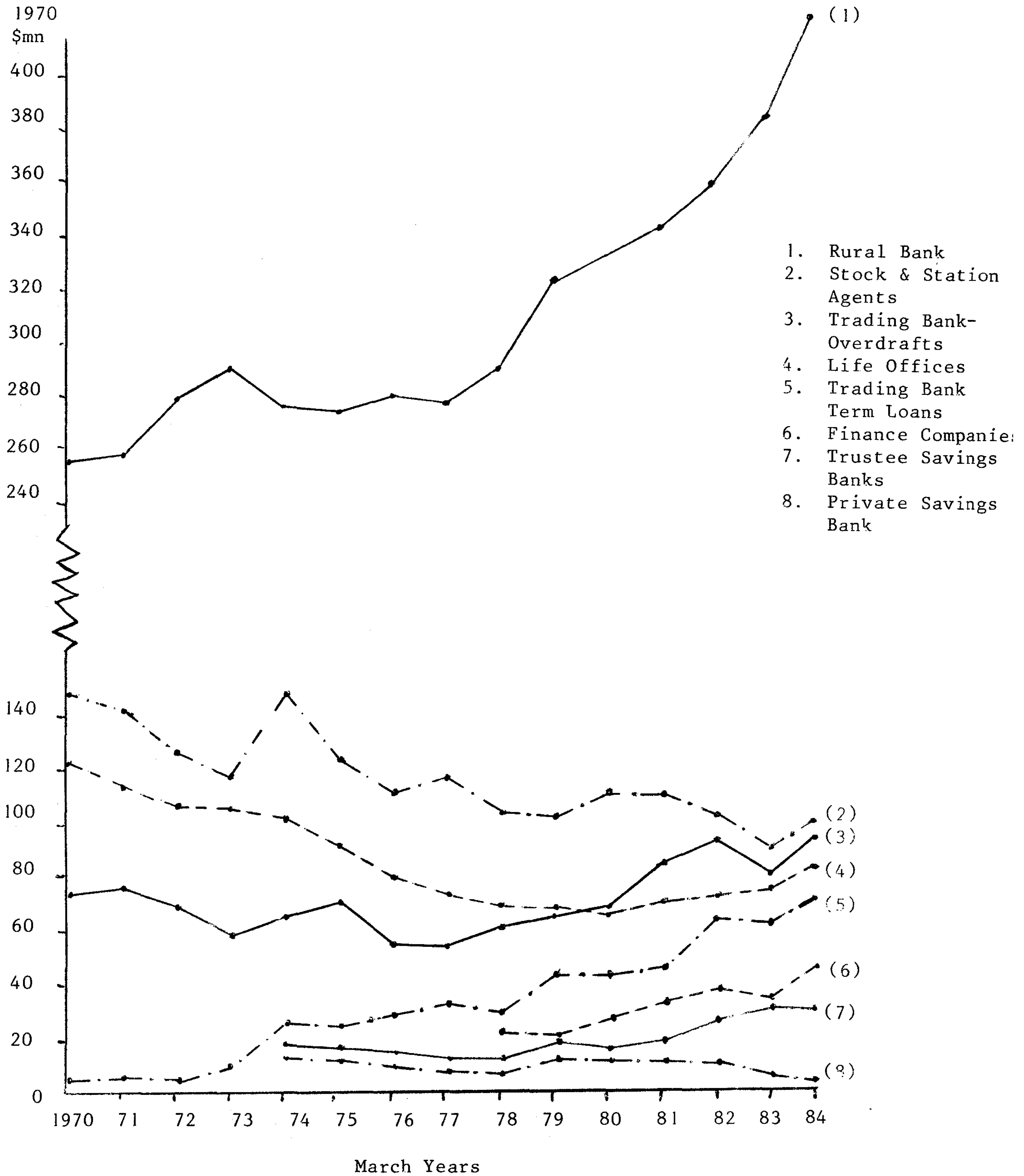
Naturally whenever farmers could meet the non-price criteria for obtaining a Rural Bank loan they would take up the Rural Bank loan rather than a private loan primarily because of the lower cost but also because of the longer terms that were available. It is unclear whether this situation reduced the role of private lending institutions. Tight liquidity in the economy over the last decade usually meant that private institutions could not meet the demand for credit. As a result the main impact of the Rural Bank is more likely to have been to expand the total agricultural credit market rather than just taking a greater share of the normal market.

Whatever the reasons behind the growth of the Rural Bank lending its impact on the agricultural credit market has been particularly felt in the last two years. In 1983/84 its influence was used by the Government to bring down interest rates. First its own

FIGURE 3

Total Agricultural Lending by Institutions-

Adjusted to 1970 Dollars



SOURCES: Rural Bank
Reserve Bank

TABLE 11

Loans Outstanding to the Agricultural Sector

as at March 31st ($m)

	Source	1977	1978	1979	1980	1981	1982	1983	1984
(1)	Stock & Station Agents	247	249	270	353	403	431	414	493
	Trading Banks	181	299	292	348	467	658	674	806
	Trustee Banks	25	27	48	48	67	111	142	141
	Private Savings Banks	15	15	29	35	37	40	25	16
	Finance Companies	50*	52	51	82	113	156	161	223
	Development Finance Corporation	5*	6*	7*	6*	6*	19*	40*	55
	Building Societies	39	42	46	49	54	61	69	82
	Insurance Companies	154	166	181	210	256	303	354	354
	Department of Maori Affairs	27	32	34	38	47	58	73	85
	Department of Lands & Survey	77	87	85	108	126	158	190	214
	Marginal Land Board	24	26	39	30	32	33	-	-
	Rural Bank	584	694	859	1043	1242	1510	1820	2026
(2)	Solicitors Trust Funds	-.01	120	153	194	247	318	389	462
	Family Loans	334	364	423	490	569	675	880	1050
	Private Sources	81	104	141	187	250	337	309	330
	Trust Companies	98	102	113	124	135	148	164	165
	Local Body Loans	15	17	23	29	38	50	42	46
	Dairy Companies	21	24	28	33	39	47	26	33
	Other	8	16	29	46	68	103	61	66
	Total	2,086	2,362	2,851	3,453	4,196	5,216	5,833	6,730

* Estimates

NOTES (1) Reserve Bank statistics and annual reports
(2) Estimates from Farmer Opinion Surveys, Pryde (1978), Pryde and McCartin (1982-85)

TABLE 12

Distribution of Farmers Total Liabilities at End of

the 1983/84 Financial Year (Per Cent)

Source	Share of Total Lending	Share of Long Term Lending	Share of Medium Term Lending	Share of Long Term Lending (1)
Rural Bank	34.8	52.7	28.6	3.1
Other Government	4.3	7.3	1.3	1.3
Trustee Savings Banks	2.1	2.7	2.0	0.7
Trading Banks	11.0	1.6	14.4	27.9
Building Societies	0.7	0.7	0.7	0.5
Insurance Companies	9.1	13.6	5.5	3.6
Stock & Station Agents	3.9	0.6	1.7	13.9
Trust Companies	2.2	0.9	3.5	3.3
Solicitors Trustee Funds	7.7	1.6	7.4	21.5
Family	12.5	12.4	14.7	10.9
Private Sources	5.8	2.5	11.9	6.5
Local Bodies	0.7	1.1	0.6	<0.1
Finance Companies	2.2	0.1	3.9	5.6
Dairy Companies	0.6	0.2	0.9	1.2
Private Savings Banks	<0.1	<0.1	<0.1	<0.1
Others	2.4	2.0	2.9	3.0
TOTAL	100.0	100.0	100.0	100.0

SOURCE: Pryde and McCartin (1985), Survey of NZ Farmer Intentions And Opinions. (2)

NOTES:

1. Long Term - over 10 years
   Medium Term - 3-10 years
   Short Term - under 3 years

2. The survey includes only farms of 20 ha or more.

lending rates were reduced at a time when commercial interest rates were showing little sign of falling. Secondly the Rural Bank's position as second or subsequent mortgagee on most farm properties was used to bring down interest rates on private sector mortgages which had a higher priority - this was done by refusing to grant priority upon renewal of the mortgage unless the interest rates were reduced to the Government guidelines.

In 1984/85 the Rural Bank's role in influencing interest rates was completely changed and not only did it cease to try and reduce commercial rates of interest but its own interest rates were increased. This process is to be continued in steps so that ultimately Rural Bank interest rates should reach levels at or near market rates.

The Rural Bank interest rate increase is being introduced in steps (Table 13) in acknowledgement of the Bank's past role - through assisting farmers to invest in otherwise uneconomic farm purchases and development - of increasing production and export earnings for New Zealand.

TABLE 13

Changes in Interest Rates on Rural Bank Loans
- Assuming Market Indicator Rate remains at 15 per cent

Oct.84 Rates	New Rates 1984/85	85/86	86/87	87/88	88/89	89/90
Existing Loans						
-Annual Review						
7.5 %	10	11	12	13	14	15
9.5 %	12	13	14	15 -----	-----	-----
11.0 %	15 -----	-----	-----	-----	-----	-----
- 3 yr Review						
7.5 %	7.5	7.5	12	13	14	15
9.5 %	9.5	9.5	14	15 -----	-----	-----
11.0 %	11.0	11.0	15 -----	-----	-----	-----
- 5 yr Review						
7.5 %	7.5	7.5	7.5	7.5	14	15
9.5 %	9.5	9.5	9.5	9.5	15 -----	-----
11.0 %	11.0	11.0	11.0	11.0	15 -----	-----
New Loans	12.5	12.5	13.5	14.5	15 -----	-----

SOURCE: 1984 Budget

Despite the stepped increase in rates Rural Bank clients will suffer much higher cost increases than the average. This is partly because of the greater proportional increase in interest rates experienced by Rural Bank borrowers than experienced by private borrowers. Although market rates fell following the introduction of interest rate regulations the response was very slow and the average for existing loans had not fallen far by the time the controls were lifted in July 1984. In contrast Rural Bank rates had been at very low average levels even before interest rate controls were introduced and had to have major increases to bring them up to market levels (Table 14).

TABLE 14

Proportions of Rural Bank Lending at Various Interest Rates - as at 31 March 1984

	Farms		Industrial		Total	
	$m	%	$m	%	$m	%
Up to 7.5%	1,088.3	52.5	10.4	5.1	1,098.7	48.2
7.6% to 9.5%	844.3	40.7	8.7	4.2	853.0	37.4
9.6% to 11.0%	134.5	6.5	125.6	60.8	260.1	11.4
11.1% to 14%	6.6	0.3	61.7	29.9	68.3	3.0
	2,073.7	100.0	206.4	100.0	2,280.1	100.0

SOURCE: Report of the Rural Banking and Finance Corporation (1984)

In addition to the higher proportional increase in interest rates Rural Bank clients have a much higher than average debt to equity ratio. This is usually because they have embarked on large development programmes or because they are new to farm ownership. As a result their debt servicing commitment in some regions has been twice that of the average farmer.

Table 15 shows how the Rural Bank's new lending rates fell behind private sector rates on new mortgages. The Rural Bank's rates were increased in the 1984 Budget and will increase in further steps to the market indicator rate but it will be some years before they reach commercial rates unless commercial rates fall from their current level.

TABLE 15

Mortgage Interest Rates (New Lending)

As at March	Average(a) Rate % (Excl. Govt.)	Rural Bank Rates % Settlement Standard	Settlement Higher	Development Standard	Development Higher	Refinance Standard	Refinance Higher
1973	8.27	7.0	8.0	5.5-7	6-8	7	8
1974	8.42	7.0	8.0	5.5-7	6-8	7	8
1975	8.61	7.0	8.0	5.5-7	6-8	7	8
		Standard	Concession Rates	Standard	Concession Rates	Standard	Concession Rates
1976	9.97	7.5	-	7.5	5.5	8.5	-
1977	11.20	7.5	-	7.5	5.5	8.5	-
1978	11.55	8.5	7.5	8.5	6.0	9.5	-
1979	12.02	8.5	7.5	8.5	6.0	9.5	-
1980	13.24	9.0	7.5	9.0	6.0	11.0	-
1981	14.87						
1982	16.51	9.0	7.5	9-11	7.5	11.0	-
1983	17.30	9.0	7.5	9-11	7.5	11.0	-
1984	13.53	7.5	-	7.5-9.5	-	9.5	-
1985	18.50E	12.5	-	12.5	-	12.5	-

(a) Includes mortgages on all types of real property
E Estimate

Sources: Reserve Bank of New Zealand
Rural Banking and Finance Corporation

The establishment of a new Commercial Division of the Rural Bank has been another major change. Although the Rural Bank was intended at establishment to bid on the open market for some of its funds it was not until 1983 that the Minister of Finance's approval was finally obtained. The first public loan market issue was made on 1 February 1984 for a total of $25m and was fully subscribed within 3 weeks.

The Commercial Division's role is to provide funds to a wide range of activities in the primary sector, which could not be accommodated under the lending policies which had to be applied to Government subsidised funds. Now the more commercial propositions can also be financed as part of a new total package for the primary sector.

In the November 1984 Budget it was announced that the Rural Bank was to ultimately seek all its new funds on the open market. Its access to new Loans Account (Government) funds is to be phased out by April 1986. In order to preserve its position as the leading financier of agriculture the Rural Bank will therefore have to meet increasing competition for funds.

4.3.2 Development Finance Corporation of New Zealand

Development Finance Corporation is a unique institution in New Zealand. As a development bank it specialises in providing longer-term and higher-risk finance and is committed to promoting economic change and development in New Zealand.

In 1980 the Corporation committed itself to the financial support of horticultural developments in New Zealand. This commitment was followed up by research into the potential of various horticultural crops and into the finance needs of the horticultural industry.

After identifying the specific needs of those undertaking horticultural development the Corporation designed a comprehensive range of financing packages designed to meet those needs.

The success of this approach was reflected in the rapid increase in the amount of Development Finance Corporation loans taken up by horticultural developers. Up to 1980 annual approvals were less than $1 million. This increased to figures of $8 million in 1981, $20 million in 1982, $18 million in 1983 and $23 million in 1984.

The Corporation's exposure to horticulture stood at $54 million in 1984 making it a significant new investor in the agricultural sector with nearly one per cent of total agricultural debt. Factors in the past which made this level of borrowing from DFC significant were: the relatively high cost of DFC funding in relation to traditional agricultural investors such as the Rural Bank, Trading Banks and Insurance Companies which in turn meant higher lending rates; the recent arrival of DFC into the market; and its emphasis on development investment rather than simply land investment.

The Corporation offers financing facilities to the horticultural industry ranging from crop finance through plant and equipment finance to venture capital for the development of new technology.

4.3.3 Department of Maori Affairs

Encouragement of better use of Maori land by the Maori owners is an important part of the Department's activities. This encouragement is provided through a Rural Lending Account (funded from the Public Account) and a Maori Land Development Fund which is funded from income from Maori Land which is farmed by the Department on behalf of the owners.

Development loans in the past, were provided from the Rural Lending Account to Maori farmers farming both Maori land and general land. However, with increasing demand particularly for horticulture development loans and limited funding, priority is now being given to the development of Maori land and individual Maori farmers farming general land are referred to other lending agencies. In the year to March 1984 $9.2 million was advanced from this account.

The Maori Land Development Fund is a revolving fund used to finance development on Maori Land (mostly pastoral stations) which the Department farms on behalf of the owners.

In total the Maori Affairs Department had nearly $82 million invested in farming from these two accounts.

4.3.4 Department of Lands and Survey

The Department's lending activities to agriculture now arise primarily out of its role as a vendor of Crown land. Its work of lending to farmers for the development of Marginal Land through the Marginal Land Board was passed on to the Rural Bank in 1983.

The greater part of the Department's advances to farmers to help them purchase Crown land are provided through the Deferred Payment Licence scheme under which lessees of Crown land can freehold the land and pay the purchase price in instalments over a period of years rather than paying cash. The other major lending activity is the financing of young farmers settling Crown Land under Part VI of the Land Act 1948. Total lending under these schemes to 31 March 1984 was $214m which places the Department as possibly the fourth largest individual lender to agriculture.

Sales of Crown land under Part VI of the Land Act 1948 were suspended in 1984/85 as a result of measures in the November 1984 Budget which made settlement uneconomic at current land prices. Following the suspension of sales the Lands and Survey Department is undertaking a review of its role in land settlement. If the Government's "more market" approach to agriculture is successful in restoring farmland prices more into relativity with returns from agricultural production then the Department may no longer have to compensate young farmers for imperfections in the land market.

4.4 Private Institutional Sources

4.4.1 Trading Banks

As a group trading banks are the most significant source of agricultural credit after the Rural Bank and family loans. They have a particularly active role in horticulture (Table 16). This increase in horticulture lending is also reflected in the growth of lending in the Reserve Bank statistics' "other farming" category in which horticulture comprises approximately 25 per cent of loans.

TABLE 16

Contributions to Rural Credit
Percentage as at June 1983

Contributor	Agriculture (excluding Horticulture)	Horticulture
Rural Bank	36.27	18.66
Other Government	4.36	3.00
Local Government	0.76	0.62
Trustee Banks	2.90	2.28
Trading Banks	8.47	18.43
Building Societies	0.55	1.11
Insurance Companies	9.94	2.89
Stock and Station Companies	2.70	2.02
Finance Companies	2.33	4.68
Solictor's Funds	6.74	9.02
Family Loan	15.49	17.38
Private Sources other than Family	5.11	10.40
Other	4.38	9.51
	100.00	100.00

Sources: Pryde and McCartin (1984)
Department of Statistics

By far the greatest role of trading banks is in short-to medium-term (less than 10 year) lending. This takes the form of overdraft facilities and term lending. Because of increasing competition for funds, uncertainty in the finance market and to a certain extent the undisciplined use of overdraft facilities by farmers, banks are shifting the emphasis in their lending from overdraft facilities to term loans.

With the moves towards deregulation of the finance industry, firstly during the 1976-81 period and then again from July 1984, trading bank lending policies have also become more flexible. This has its effects in decentralisation of decision making - so that loans are made with more regard to individual circumstances - and with more lending packages appropriate to the needs of agriculture. Examples of the latter are deferred principal loans and the development of total finance packages for family operated horticultural units.

The cost of trading bank finance has moved up quickly in line with the cost of funds as term loans interest rates and particularly overdraft interest rates can be reviewed at short notice. With the Reserve Bank requirement to favour agriculture no longer in force rates on farm loans now follow the general shift in interest rates.

The demand from agriculture for trading bank funds at the time of writing is low due mainly to the high cost of borrowing and to some extent industry uncertainties resulting from the Budget changes and changes in world markets.

In addition to the lower demand there has also been a significant reduction in seasonal requirements as farmers benefit from a good 1984/85 growing season and better prices as a result of devaluation. This is expected to reverse during the last quarter of 1985 when the demand should increase to a level around 10 percent above the previous year. The demand is expected to be even stronger during 1985/86 as the effects of recent policy changes filter through into costs without corresponding increases in prices.

Overall, banks are likely to be in a position to fund the demand for finance but will be taking a more cautious approach to lending and the valuation of farm property, taking into account falling land values in some areas and recent Budget measures.

4.4.2 Stock and Station Agents.

Stock and Station Agents endeavor to confine their lending to seasonal finance. Poor farm incomes over the past three years have contributed to seasonal finance becoming hard core debt. However the rise in farm incomes for the 1984/85 season has resulted in some reduction in this hard core debt. Improved availability of finance from other institutions following the 1984 removal of interest rate controls has allowed the transfer of further hard core seasonal finance to term loan accounts.

For Stock and Station Agents the rising cost of funds from the mid 1970's until 1983 and a series of controls on their interest rates impaired their ability to attract sufficient funds to meet demand. Following the decontrol of interest rates the higher cost of borrowing is reducing the demand for funds and Stock and Station Agents are generally in the position of being able to service the requirements of clients who can maintain a viable operation.

Their ability to meet demand was tested at the beginning of the 1984/85 season when seasonal requirements were 30 percent higher than the previous year. The market appears to have settled for the present with seasonal borrowings being on a par with the previous season. Over the next 2-3 years the demand is expected to pick up again by around 10 percent annually.

A recent development in Stock and Station Agent's farm financing has been closer association with finance companies, particularly those within the corporate group. Perhaps through this association more innovative financing packages are being developed such as the financing of syndicate operations, leasing arrangements for deer, goats and bloodstock and term loans with flexible capital repayments.

4.4.3 Life Insurance Companies

Life Insurance Companies are the main source of long-term credit after the Rural Bank. Their share of long-term lending has been increasing over the past three years as their real level of lending has increased and other lenders (including the Rural Bank) have moved

towards reducing the average term of loans. Between 1982 and 1984 Life Insurance Companies' share of long-term lending increased from 10.1 per cent to 13.6 per cent (Pryde and McCartin 1983, 1985).

Figure 1 shows the declining importance of Life Insurance Companies up until 1980. This was most probably due to lack of funds as demand for finance by farmers invariably exceeded supply. The reversal occured in 1980 when recession made the public more security conscious and their life insurance investments increased. This increase was passed on into farm lending as until 1984 Life Insurance Companies were obliged to invest 20 per cent of their funds in farm and housing loans.

The removal of this Government requirement has not greatly affected the Life Insurance Companies' rate of investment in agriculture in the short-term. Increasing interest rates have had greater impact by depressing demand. This fall in demand means that Life Insurance Companies are now in a position to meet requests for finance where the farmer has suitable security and life insurance association and has the ability to service the resultant debt.

Generally, lending policies to agriculture have not changed over the last 12 months, though farm mortgages are not now as likely to attract the preferential interest rates which they have in the past.

4.4.4 Finance Companies

Most of the agricultural lending by finance companies is for the purchase of machinery. However some companies have become involved with other forms of agricultural lending such as crop finance and land purchase. This move occured during the late 1970's and early 1980's when kiwifruit development was at its peak.

With the tightening of the money supply and imposition of controls on interest rates in 1983 these companies became concerned with their exposure to agriculture and in particular horticulture. Perhaps as a reaction to this the share of total lending to agriculture taken by finance companies declined slightly between 1983 and 1984.

Finance companies are primarily short-term lenders with very little lending for terms of more than three years. This is revealed in an analysis of short-term lending to agriculture of which finance companies provide nearly 6 per cent. In comparison long-term lending by finance companies meets only 0.1 per cent of the total used in agriculture.

4.4.5 Trust Companies

Trust companies were one of the traditional long term financiers of agriculture but had a much smaller role than insurance companies. They are not covered in Reserve Bank financial statistics which makes it difficult to assess their contribution to agriculture and any changes that have occured over recent years. From the results of a survey of farmer opinion (Pryde and McCartin, 1985) Trust companies appear to contribute 2.2 per cent of total agricultural credit (Table 12).

There has been little if any change in trust companies' lending policies towards agriculture over the past two years. Currently there is limited demand for their funds and depending on the debt servicing ability of the applicant they are able to meet all propositions as they arise.

4.4.6 Trustee Banks

Trustee Banks have grown in importance as agricultural lenders in recent years and their contribution is now on a par with that of Trust companies and Finance companies.

Lending is primarily in the form of long-term mortgages and medium- term "term loans". Government approval was given in 1981 for Trustee Banks to offer overdraft facilities but by 1984 these facilities still only accounted for 8.5 per cent of lending.

Currently demand for funds from the rural sector is light and the Banks have no trouble providing funds for those that meet the qualifying criteria. To a large measure the limited demand from potential borrowers is attributed to both the 1984 Budget measures and the dramatic increase in interest rates following deregulation and the high rates paid in recent Government Stock tenders.

4.4.7 Offshore Loans

Offshore loans are becoming an increasingly popular means of raising finance for agriculture. Prior to the July 1984 devaluation of the New Zealand dollar this method of financing carried with it a considerable exchange risk. The high cost of forward cover to offset this risk did not deter a growing number of farmers as they did not have access to any other form of finance when local funds dried up as a result of interest rate controls.

With devaluation and the removal of interest rate controls the exchange rate risk was considerably reduced and the main reason for borrowing offshore became the low cost of funds compared to New Zealand. The other factors are the longer terms that can be obtained (to 15 years in many cases) and ease of access which is still important where large sums are involved.

The extent of offshore borrowing for agriculture is not recorded in national statistics and is difficult to obtain from farmer surveys as it is not peculiar to any one institution - Trading Banks, Finance companies and Stock and Station Agents can all offer access to offshore funds. One finance industry estimate of offshore agricultural funding is in excess of $300m.

4.5 Private Non-Institutional Sources.

4.5.1 Family Loans

Family loans are the largest source of agricultural credit after the Rural Bank (Table 12). Reasons behind the use of family funds are probably lower costs, greater security in economic downturns and the longer terms that have been available. The latter may not be as significant now as family loans are on average being made on shorter terms probably because of uncertainty over future rates of inflation.

4.5.2 Solicitors' Trust Funds

Solicitors' Trust Funds contributed 7.7 per cent of agricultural credit as at June 1984 (Table 12). This source of credit grew in importance during the 1970's and early 1980's. As the combination of inflation and Government regulation of the institutional sources made it increasingly difficult for farmers to obtain credit, Solicitors' Trust Funds became a popular source.

The absence of interest rate controls - at least until 1983 - and the generally low administration charges of solicitors (less than 1 per cent) made this an attractive channel for investors. The short terms of the loans (less than 3 years) were a disadvantage to farmers but the alternative was usually no finance at all.

One considerable advantage to borrowers was that the loans were usually made on an interest-only basis. This was particularly helpful to those developing horticultural properties and loans through Solicitors' Trust Funds have been a common source of finance in new horticultural areas such as the Bay of Plenty. The short term of these funds and the need for regular renewal became a serious problem in 1983 after interest rate controls were extended to solicitors' funds and the supply dried up.

4.5.3 Returns to Investors

It should not be overlooked that a considerable proportion of farmers are either direct lenders to agriculture or depositors with lending institutions. While high interest rates are to the disadvantage of the majority of farmers there are also a proportion who stand to benefit. These latter have at times, particularly with high inflation, been making losses in real terms on their savings. At present inflation and interest rates they have an opportunity to make a profit in real terms. This should encourage saving again and will be of particular benefit to young farmers saving towards farm purchase.

SECTION 5

CONCLUSIONS

This report attempts to review a period during the last two years in which dramatic changes in economic and monetary policy have occurred. All measures have had an impact on the rural credit situation.

For example at the beginning of the period finance was generally cheap but difficult to obtain. At the end of the period finance for agriculture is relatively easy to obtain but at high cost. What has probably been most damaging to the farming sector has been the impact of the change from one extreme to the other.

Over the past 15 years farmers have come to rely heavily on Government assistance and one of the side effects of this has been an acceleration in land values. With the removal of subsidies some farmers are facing difficulty in meeting debt commitments on borrowings against farmland which was over-valued in relation to the returns from it.

While the devaluation of 18 July 1984 was undoubtedly of help to the export sector its beneficial effects were clouded by the operation of the SMP scheme. In the case of the sheep industry the New Zealand Meat Producers' Board derived much of the benefit through reduced pressure being placed on its own price support operation.

The dismantling of controls on the operations of the financial institutions gave them more freedom to operate without Government coercion. However as the institutions could not unload quickly the lower yielding Government securities they had been forced to purchase, a rapid change in lending policy was not expected. But with the continuation of much of industry protection as compared to the almost immediate abolition of much of the support for agriculture there is a danger that the industrial sector will have greater appeal to investors. The authors received reports that such a change in investment preference has already occurred to the detriment of agriculture.

It was evident that the previously noted trend toward a shortening of the term for loans to agriculture has accelerated over the last two years. Even the Rural Bank, traditionally a long-term lender to agriculture has been affected by the necessity to borrow short - this will make long-term lending more difficult. To agriculture this trend is unhelpful to an industry where the gestation period for much of its investment projects extends over a long period.

Trading banks continue to increase their share of agricultural lending. However a relative decline in the overdraft system of seasonal financing has occurred as farmers have had to resort to more term lending. Here again it is considered that such a trend is undesirable as the overdraft system is especially appropriate to the needs of agriculture.

It has become apparent that an increasing level of farm costs is reducing significantly the benefits of the 1984 devaluation. This effect will be accelerated by the effective ending of the SMP scheme for the sheep industry at the end of the 1984/85 season. Higher interest rates have added to the problems of the industry and for some farmers their interest payments as a proportion of gross income are reaching a disturbingly high level.

The authors noted some trends towards an agricultural credit system better tailored to the needs of agriculture. For example efforts are now being made to introduce a system where borrowers secure all their credit needs from a single institution. Notwithstanding this innovation it was generally observed that most improvements in lending facilities were in the commercial and industrial sectors.

Until such time as Government reduces its budget deficit before borrowing, there is little prospect of reducing upward pressures on interest rates in the money market. This means Government must not only look to enhancing its revenue but also reducing expenditure. The Rural Bank now has to depend increasingly on raising its funds on the open market. This freedom which was provided for in its 1974 legislation was not granted until 1982. Since then the money market has been coming under increasing pressure from competing borrowers, in particular the Government. It is obvious that the Bank, under present conditions, will have great difficulty in securing adequate long-term finance. The impact on agriculture could be serious.

In a monetery environment of high internal interest rates, it is not surprising that private offshore borrowing for agriculture has developed on an expanding scale. But while savings from lower interest rates are considerable these could be more than offset by exchange losses should the New Zealand dollar continue its past rate of decline. Farmers are in general price takers and do not have the natural hedge against devaluation which has been assumed for exporters generally.

Farmers' main concern now is their ability to service debt. The cost of finance is the most significant factor causing this concern. However interest rates charged to farmers are generally no higher than those charged to other sectors of the economy. What sets farming apart from other sectors is its inability to offset the extra cost by raising their prices.

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