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The Cost of Money: Agriculture and Leverage

Jump in the time machine with me for a moment back to 2019: walk into a grocery store and you could find a gallon of milk for $2.90. Back to the present, it may cost you $4.09 on average for that same gallon.

Price inflation is universal. There are many factors that have influenced this phenomenon, including in no small part the increasing cost of capital measured through interest rates. As consumers, we certainly face these changes in our credit card bills, mortgages, and car loans. However, many farmers and ranchers today bear an incredible interest burden and are exposed to these risks in ways we as consumers can hardly fathom.

For context, in an effort to support the economy following the COVID-19 pandemic, the Federal Reserve began a strategy termed, Quantitative Easing, in which the central bank would purchase government bonds and other financial instruments in the market to stimulate market liquidity, keep interest rates low, and maintain lending for businesses to keep the economy in working order.

The Federal Reserve continued this policy until January, 2022 when it became increasingly apparent that price inflation–the degree to which the price of a set of goods increases over a period of time–reached significantly high levels. The Consumer Price Index reached a high of 9.1% in June, 2022. To enact change, the central bank began increasing the federal funds rate–the interest rate the federal reserve charges banks for more capital–and has done so 11 times since March, 2022. This is fundamentally important: increasing interest rates makes money more expensive for borrowers, therefore less attractive, and therefore less likely to continue spending additional money that would otherwise add fuel to the inflation fire.

Back on the farm, agriculture as a sector is a highly capital intensive industry, meaning that farms spend a lot of money to make money. This most often comes in the form of land, equipment, infrastructure, and inputs (seeds, fertilizer, feed, etc.). With this, farms may take on "operating loans" or short-term loans to buy inputs in addition to longer term debt for larger purchases.

These add-up over time, so much so that the most recent estimate from the USDA estimates that the total farm sector debt would reach $535.09 billion in 2023–the highest on record. The majority of this staggering figure comes from real-estate debt being longer duration, fixed rate loans that may be partially insulated from these recent interest rate changes if the farmer sought the loan before 2022.

Yet shorter duration and operating loans still make up about 30% of total debt. No less, the USDA estimates that given the rising interest rates, interest expense is set to become the third largest farm production expense and the fastest growing category of production expenses.

Debt management is fundamentally important to the overall risk mitigation strategies of a farm enterprise. Eliminating debt (or at least reducing it), is an outstanding objective in the long-run, though it may not always be a winning strategy in the short run. As markets change and opportunities present themselves, farm businesses may be encouraged to take on additional debt to expand their operations. It is important, however, to evaluate the repayment capacity of an enterprise in both the dollar value as well as the difference between return on investment and the rate of the loan.

The good news in all of this, is that at the time of writing this the Federal Reserve has not only kept the federal funds rate unchanged but has also recently signaled three potential rate reductions in 2024.

Maybe Christmas came early this year!

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