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The financial position of South African Agriculture

G Coetzee, F Meyser & H Adam

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Department of Agricultural Economics,
Extension and Rural Development
University of Pretoria
Pretoria, 0002

South Africa

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Abstract

The agricultural sector in South Africa is subjected to major changes due to a simultaneous influence of external and internal forces after the political changes in South Africa and its opening to the rest of the world. The external forces are mostly linked to increasing globalisation including a changing international trade regime. Internal forces have to do with the liberalisation of agriculture and for example the changing role of government with respect to the provision of financial services. This paper indicates the effect of these influences on the financial position of the farming sector and provides a point of departure for the monitoring of future trends. It further indicates the strategies followed by farmers to counter the negative trends experienced. It is a component of a much broader study on the agricultural finance situation in South Africa.

1. Introduction

Agricultural finance in South Africa stands at the crossroads. An era of direct state involvement is slowly drawing to a close. This is evident in the closure of the last direct intervention in the agricultural finance market by the South African government, the Agricultural Credit Board, and the direction indicated by formal agricultural policy. It is happening at a time when the Government emphasises ease of entry for those farmers hitherto being constrained and prevented to join mainstream agriculture in South Africa. This creates the perception of conflicting policy objectives. The Land Bank tasked by government to attend to financing development agriculture while retaining its commercial financing responsibilities, reacts by aggressively expanding its commercial financing. Commercial banks react to this by taking legal action. Questions are being asked on the future of agricultural finance in the country and the role of the government.

It is opportune to gauge the current state of agricultural finance at this turning point. In this paper the question is being asked: What is the financial position of the agricultural sector? Surely we should depart from an informed point. This paper is one section of a far larger study being executed. It attempts to describe the main trends impacting on farming in South Africa, and therefore, due to the derived nature of finance, impacting on the financial position of the agricultural sector. These main trends are discussed in section two and the impact on the financial position of the agricultural sector is explained. The paper is concluded with a discussion of the findings and an attempt at crystal ball glazing, thus what holds the future.

Main trends impacting on the agricultural sector and the influence on the financial position of the sector

An overview of the general nature of agricultural policies in South Africa during the years under consideration is necessary in order to understand the economic movement of the agricultural sector as a whole. The discussion on agricultural policies can be divided into two time periods, the 1980's and the early 1990's and the time period as from 1994 when the government of national unity came to power (Kirsten & Vink, 1999). These two researchers classify the main policy shifts in the 1980's as:

- Deregulation of the marketing of agricultural products in terms of the Marketing Act and other legislation.
- Changes in fiscal treatment of agriculture, including the abolition of many tax breaks that favoured the sector and a reduction in direct budgetary expenditure on the sector.
- A start to the processes of land reform, reforms of labour legislation, and trade policy reform.

Policy shifts as from 1994 include:

- The promulgation of the Marketing of Agricultural Products Act, No 47 of 1996 which represents a radical departure form the marketing regime to which farmers had become accustomed in the period sense the 1930's.
- Trade policy reform aimed at reversing decades of 'inward industrialisation' strategies.
- Labour market reform, which involves the continuous application of legislation that governs the occupation rights who live on farms, and
- Reform of the state's approach to financial support to the agricultural sector

The effect of monetary policy on the agricultural sector is important, especially with regard to the depreciation of the Rand exchange rate as well as the farm debt problem and interest rate variability. As can be seen from figure 1 a negative real interest rate mainly occurred during the 1980's. The reason for this being that the government followed an expansionary monetary policy that implies an increase in money supply (Kirsten and Vink, 1999). This gave rise to the depreciation of the Rand exchange rate, which resulted in the rise of the costs of imported components of machinery, implements, dips and sprays. The expansionary monetary policy resulted in a high inflation rate (represented by the CPI) which resulted in the negative real interest rate. However, in order to curb inflation the government started to implement a policy of positive real interest rates from 1988 onwards.

Agricultural debt (deflated by the index of all farming requisites to eliminate the effect of inflation) reached a maximum level in 1985. This phenomenon is mainly due to three factors (Van Schalkwyk and van Zyl, 1995):

- The negative real interest rate has brought about a higher level of borrowing than otherwise would have occurred.
- Subsidised interest rates further increased the availability of cheap credit in the early 1980's, which led to an increased willingness of the farmers to borrow more funds.
- The severe drought of 1982/1983 caused cash flow problems, which resulted in a decrease in repayment ability of the farmers.

After 1985 a steady decline in real total farm debt occurred. Financial institutions started to acknowledge the increased risk of the agricultural sector (especially when some of the subsidy programmes started to be decreased and withdrawn) and a more strict credit repayment program was followed. Farmers also acknowledged the

increased risks and decreased borrowing of funds. It is thus clear that three prices- interest rates, foreign exchange rates, and inflation have a major impact on the financial structure of the farming sector

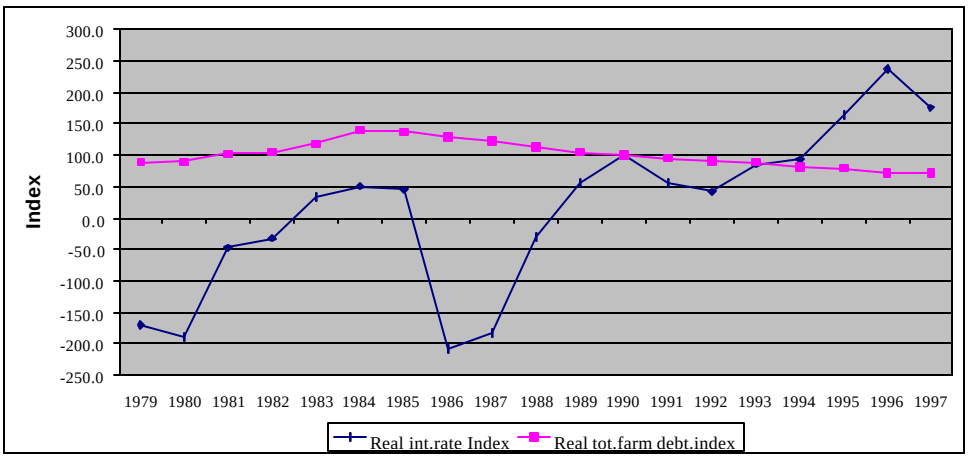

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Figure 1: Trends in real interest index and real total farm debt
Source: SARB Quarterly Bulletin, March 1999 (Constant 1990 prices), Abstract of Agricultural Statistics

Figure 2 serves as an indication of the trends in the capital assets structure of the South African agricultural sector. Because the low or even negative real interest rates encouraged borrowing, land prices were pushed up above the productive values of land. According to Van Schalkwyk and Van Zyl (1995) the real price of land peaked in 1976. As the real interest rates then started to increase the price of land decreased. Figure 2 illustrates this part of the movement of land prices in reaction to real interest rates increases. This can be linked with the discussion on real debt from figure 1. Van Schalkwyk and Van Zyl (1995) argues that the lag between the 1976 real land price peak and the 1985 debt peak is a direct result of the expectations of agricultural financiers that real farmland prices would increase. This is one of the reasons for the downward trend of the "real land and fixed improvements" index in figure 2. In order to compensate for inflation the nominal index was deflated by the combined index of land values (Van Schalkwyk & Groenewald, 1993).

The real index for machinery and implements was calculated by deflating the nominal index with the all farming requisites index and the real index for the total value of livestock was calculated by deflating the nominal index with the producer prices for animals. It seems more than probable that there was a degree of over- mechanisation in the seventies and early eighties with these negative real interest rates. As interest rates increased and the financial position of the farmers deteriorated farmers could not afford to replace their machinery frequently. This implies that the life span of these assets had to be increased that automatically resulted in the downward trend in the value of machinery as can be seen from the figure below. These trends are echoed by Coetzee & Viljoen (1990).

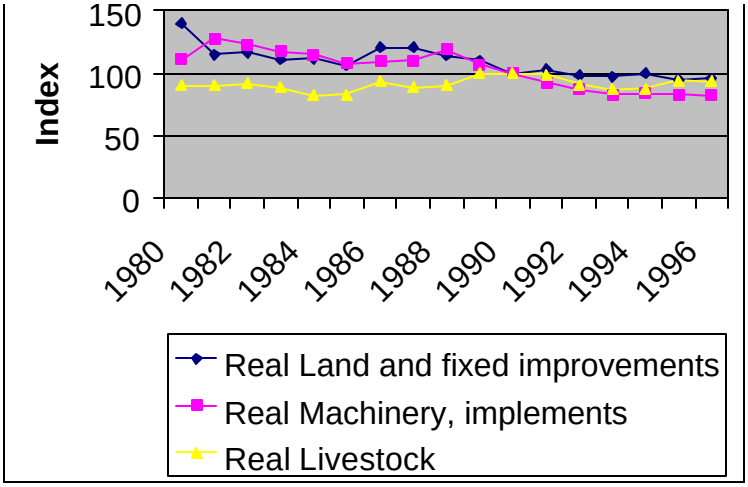
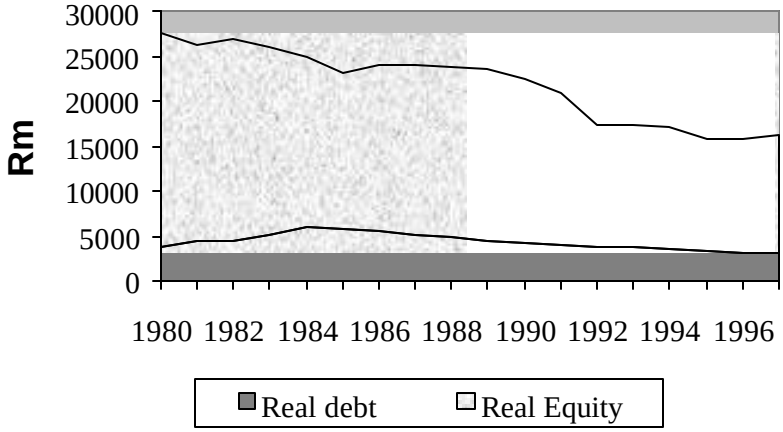


Figure 2: Capital asset distribution
Source: Abstract of Agricultural Statistics, 1999

Interest rates thus also have an impact on the inventory behaviour of farmers. Higher interest rates raise the cost of inventory investment, causing stocks to be run down. It is however interesting to take a closer look at the trend of real livestock assets. There was rather a slight incline than a decline in the total value. This may be explained by the government programmes aimed at converting marginal crop areas in grazing and the increasing awareness of farmers of the high risk of crop production in marginal areas. A large contributing factor to this level of risk is South Africa's unstable weather patterns.

It is thus inevitable to draw the conclusion from this data set that the real value of total assets of the agricultural sector has declined over the past one and a half decades. This can also be seen from figure 3. According to the well know equation, the sum of real debt and real equity is equal to the total real assets, it can be seen from the negative slope that there was a decline in the total assets. The negative trend between debt and equity in the early eighties, as indicated by figure 3, can be explained by the fact that the severe drought of these years forced farmers to repay their loans by using



their equity.

Figure 3: Real debt and real equity
Source: Abstract of Agricultural Statistics, 1999

Although the total value of assets has decreased it does not necessarily imply that the financial position of the farmers has deteriorated drastically in terms of the different ratios that can be calculated. If the leverage ratio, which serves as an indication of the farmers ability to meet their total liability by using own capital, is calculated it is evident that except for a deterioration in the early eighties, this ratio has stayed fairly constant over the past decade. One of the reasons for this is the steady decline in the real debt value over this period.

The high level of inflation and the deterioration in the exchange rate serves as contributing factors for the cost price squeeze where margins between input costs and producer costs become smaller. It was only in recent years that the government was able to reduce inflation. The devaluation of the Rand however continued at an increasing rate.

All of the factors mentioned above led to the decrease in real net farm income (NFI) of round about 2% over the past two decades. This figure was calculated by using the data set of NFI taken from the Abstract of Agricultural Statistics for South Africa (1999).

Fiscal policies also impact on the financial situation of the farming sector. Fiscal policies are the attempt by the government to meet employment, income, growth and distribution, and other objectives through its powers to tax and spend. Gross domestic fixed investment in agriculture as a percentage of total gross domestic investment shows a decline from 4.38% in 1986 to 3.50% in 1997 (Figure 4).

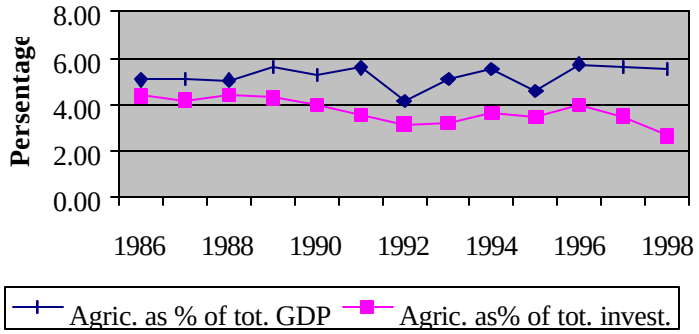


Figure 4: Trends in agricultural investment and GDP as a percentage of total GDP.
Source: SARB Quarterly Bulletin, March 1999 (Constant 1990 prices)

Based on the earlier discussion one can identify a few major reasons for this deteriorating investment trend, apart from the unstable weather conditions in the country. Firstly, high increases in input costs due to the weakening exchange rate and also an increase in the cost of inventory because of the high level of interest rates. The reason for the major decline in investment from 1988 to 1992 can partly be explained by the increased political uncertainty, which led to a decrease in the confidence level of the agricultural sector. During the early 1990's the focus of government investment shifted towards social sectors like education, health and housing. This also led to a decline in investment in the agricultural sector.

Interesting to note is that no drastic decline was observed in the agricultural GDP as percentage of the total GDP. A higher level of productivity in the agricultural sector may explain this. This trend can mainly be explained by the changing weather pattern, for example, the impact of the severe drought of 1992.

Conclusion

The agricultural sector reacted directly to the changing environment within which it is practised. What is evident is a major impact on the profitability of farming. Although we experience a negative trend at the moment it is clear that farmers react to severe conditions by changing their strategies, in this paper, specifically financial strategies. This is shown in their changing credit use pattern and the decline in the real liability profile of the farming sector. Further research will identify more strategies within production and marketing that are applied to counter negative influences on the farming sector.

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