

The Main Street Economist

Commentary on the rural economy



2006

FEDERAL RESERVE BANK of KANSAS CITY

A ROBUST RURAL ECONOMY

JASON HENDERSON, SENIOR ECONOMIST

Rural America will remember 2005 as a year of hurricanes, drought, and surging gas prices. But these disasters did not stop the farm sector from posting another banner income year—nor did they stop the Main Streets from enjoying solid gains in employment and income.

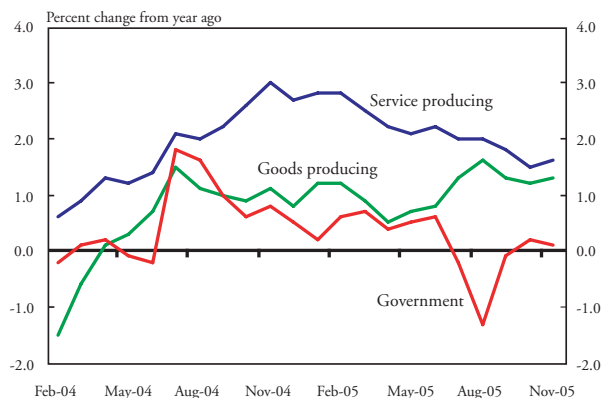
Heading into this year, the rural economy appears poised for another round of robust activity, especially if private sector forecasts hold true. The biggest threat to this positive outlook appears to be higher energy prices. Rising oil and natural gas prices quickly translate into higher production costs for factories, farms, and households. Still, higher energy prices are also underpinning a new wave of investments and market opportunities in rural America's emerging bio-based energy sector.

CONTINUED RECOVERY IN 2005

Main Street businesses continued to make solid job and income gains last year, as rural payrolls rose 1.2% during the first three quarters of the year, matching metro areas and pushing rural unemployment down from 6.0% to 5.7%. Sustained job growth translated into stronger incomes, which strengthened in the second half of the year. In rural areas, average weekly earnings growth averaged a solid 2.4% during the first ten months, slightly below the 2.6% rate in metro areas.

The economic strength on Main Street was broad-based, with both services and goods-producing sectors adding jobs (Chart 1). Rural service firms continued to lead the way, with 1.6% annual growth in November. Professional and business service firms added jobs at a 3.7% clip. The strength in such firms, which tend to employ people with higher skill levels, signaled the continuing transformation of the rural economy toward high-skill activity. Wholesale, transportation and utility sectors grew solidly, and recreation service growth stayed strong despite easing in the summer and fall due to higher gas prices. Job growth in recreation destination counties grew 3.5%.

Chart 1
Rural Business Job Growth



Source: Calculations based on Bureau of Labor Statistics Data

The rural goods-producing sector also strengthened, thanks to strong construction and mining activity and stable rural factories. By the third quarter, annual job growth in these sectors crested at 1.5%. Residential construction continued to expand as housing permits rose 3.8% during the first ten months. Surging oil prices underpinned strength in mining as oil companies expanded rig activity. Rural factory closures and mass layoffs continued to abate, and job rolls edged up for the year.

The strong growth in rural services and goods-producing firms overcame weakness in rural government sector employment. Government jobs expanded less than 1%. Gains were weak despite improved fiscal conditions for state and local governments.

ANOTHER BANNER YEAR FOR AGRICULTURE

Despite drought and hurricanes, the farm sector enjoyed its second-largest year on record for net farm income, topping \$71.5 billion (Chart 2). This figure stayed just 13% below the 2004 record despite rising production costs, which trimmed strong livestock and crop incomes.

Strong consumer demand for meat in both domestic and foreign markets continued to bolster livestock in

2005. In domestic markets, per capita red meat and poultry consumption reached its second-highest level on record, trailing only 2004 levels. Foreign consumption was also strong as red meat exports rose 30%. Pork exports stayed strong as exports to Japan and South Korea (countries that continued to ban the import of U.S. beef in 2005) set record highs. Beef exports to Canada and Mexico strengthened as these countries opened their borders to U.S. beef. In December, Japan finally announced it will allow the importation of U.S. beef from animals under the age of 20 months. While this came as welcome news, some analysts suggested it will take several years to rebuild the Japanese market.

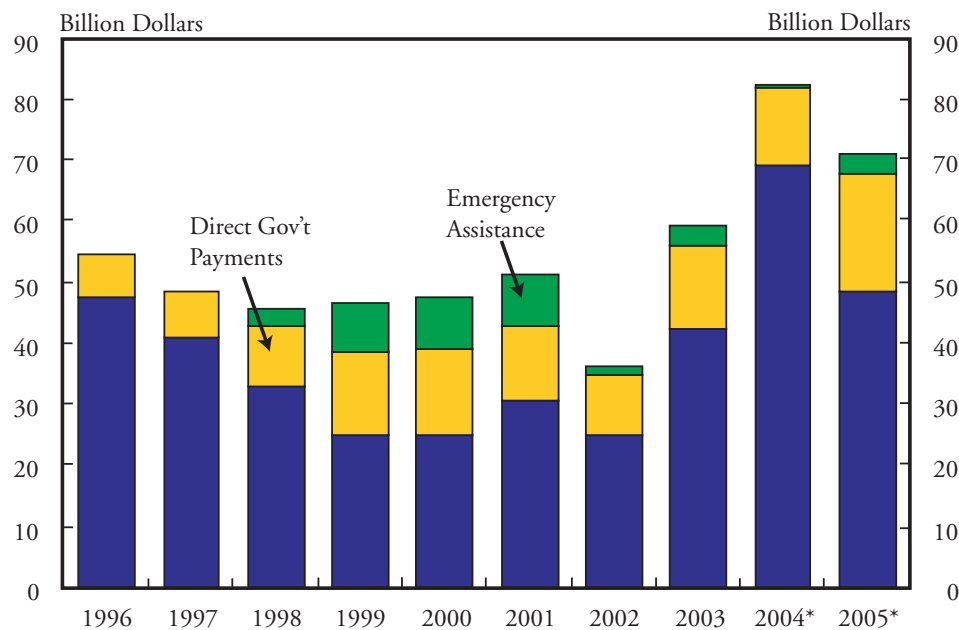
Even in the face of high prices, livestock producers showed restraint in boosting output. High prices typically lead to a chain of supply increases as producers start rebuilding breeding stocks. In 2005, cattle slaughter edged down as producers retained heifers and cows for breeding. Still, actual meat production rose as producers sent larger animals to slaughter. For the livestock segment as a whole, total red meat and poultry production inched up 1.7% in 2005.

Strong demand and lean supplies led to high prices and profit opportunities for most segments of the meat

industry. Hog producers enjoyed the biggest profit opportunities, as market prices stayed well above break-even levels throughout the year. Cattle ranchers benefited from feeder cattle prices that approached record levels. But strong feeder cattle prices limited profit opportunities for feedlot operators as fed cattle prices just covered break-evens throughout most of the year.

While the Midwestern drought and the record hurricane season devastated certain regions of the country, they barely

Chart 2
U.S. Net Farm Income



Source: USDA

influenced national crop production. According to USDA, drought in the Midwest led to soybean and corn production losses of \$221 and \$486 million, respectively. The losses were concentrated in Arkansas, Illinois, Indiana, Missouri, Ohio and Wisconsin. Hurricanes Katrina and Rita led to \$882 and \$195 million in crop production losses, respectively, mainly in the South. While large, these losses accounted for only a small portion of U.S. gross cash receipts. In fact, the 2005 U.S. soybean and corn crops were the second-largest on record and, coupled with a big 2004 crop, led to large amounts of the crops held in storage.

Big crops led to lower prices for producers. Despite drought, bin-busting corn and soybean crops pushed farm prices for the 2005 crop below the 2004 average. While wheat production was down 2.8% from a year ago, average farm prices fell below 2004 levels due to weaker demand.

Lower prices led to a surge in government payments. Subsidies were expected to reach \$22.7 billion in 2005, up 70.7% from 2004. The biggest gain, \$4.8 billion, was in the loan deficiency programs and countercyclical programs, which increase payments as prices fall. Ad hoc and emergency payments also rose \$3.1 billion, with a sharp increase in disaster assistance payments.

While the national production impacts of Katrina and Rita were small, the hurricanes intensified input price pressures on farmers throughout the nation. Fuel and oil prices were already rising before Katrina and Rita, but prices spiked in their wake. For 2005 as a whole, fuel and oil costs for farmers jumped an estimated 40%. USDA estimates that farm production costs go up \$85 million every time fuel prices rise 10%. Crop producers, especially wheat and corn producers, which typically spend proportionately more on fuel and oil, are expected to bear the brunt of the rising prices. Costlier nitrogen gas is expected to lead to additional gains in fertilizer prices in 2006.

Despite rising costs, stronger incomes helped the farm balance sheet. Farm debt ratios fell in 2005 as farm equity gains outpaced rising debt. Nationally, farm real estate equity rose 7.3%, with some regions posting record farmland value gains. For example, in the Tenth Federal Reserve District, ranchland values surged 13% above

last year. Strong land value gains continued to be fueled by robust investment and demand for recreational and residential land.

MORE OF THE SAME IN 2006?

The rural economy appears ready to reap another year of prosperity, especially if the national economy grows as private sector forecasters expect. Given supply and demand conditions, the farm sector could reap another bountiful year. Higher energy prices pose a risk to the rural outlook—but could also help spur a promising set of new investments in rural America.

Robust nonfarm growth. Activity on Main Street should stay strong in the year ahead, as rural growth follows national economic growth. Various analysts and forecasters expect 2006 to be strong for the national economy, with economic output expanding 3.5% in the first half to 3.1% in the second half (Gerena-Morales and Annett). According to the Institute for Supply Management, growth could be broad-based as both manufacturers and nonmanufacturers are expected to enjoy solid gains.

As a result, job gains in goods-producing firms that strengthened as 2005 progressed should underpin continued resiliency. National indicators suggest robust manufacturing activity in the year ahead. Higher energy prices should continue to fuel solid growth at rural mining and mineral extraction firms. In service sectors, rural business job gains are expected to continue, with strong gains in high-skill industries. Many firms are engaging in “homeshoring,” outsourcing service-based jobs to rural America instead of overseas. By taking advantage of lower costs than in major metro markets, but closer proximity to firms, several businesses garnered media attention in 2005. For example, wages for software developers are \$35 to \$40 per hour in rural areas, compared to \$75 to \$100 per hour in major metro markets and \$20 per hour in India (Hall).

Another solid year for agriculture. Despite lower projections for farm prices, farm incomes in 2006 are likely to remain healthy by historical standards. Livestock revenues will likely stay robust as rising output offsets lower prices. Total red meat and poultry production is expected to rise 3%. While meat exports are expected to match this 3% rise, domestic consumption is expected

to rise a more modest 1.7%. With production outpacing consumption, prices are expected to ease slightly yet remain above historical averages (Table 1).

Fertilizer prices also rose last year, and the jump in natural gas prices will probably translate into even higher fertilizer prices in 2006. Rural nonfarm businesses also face rising input costs due to higher energy prices.

Table 1
USDA Annual Price Projections

Livestock Prices (Dollars per hundredweight)			
	2006	2005	Average 2001 to 2003
Choice Steers	79-85	87.09	74.81
Feeder Steers	97-103	111.23	86.03
Hogs (barrows and gilts)	44-47	50.01	40.06
Broilers	68-73	71.00	58.90
Milk	13.35-14.15	15.10	13.20

Crop Prices (Dollars per bushel)			
	2005/06	2004/05	Average 1998 to 2001
Corn	1.60-2.00	2.06	1.90
Wheat	3.25-3.50	3.40	2.63
Soybeans	5.00-5.70	5.74	4.4

Source: Livestock, Dairy, and Poultry Outlook report and World Agricultural Supply and Demand Estimates, USDA, December 2005.

Energy prices will have an even bigger economic impact on rural area than metro areas, given their industry mix. For example, rural manufacturers are more concentrated in energy-intensive industries, with more than a third of rural manufacturing earnings coming from industries with above-average energy costs, compared to a quarter for metro manufacturers.

Rural residents are also challenged by higher energy prices due to their reliance on the automobile and longer commuting patterns. With surging gas prices, commuting costs have increased substantially. According to the Consumer Federation of America, rural households in 2005 spent \$2,087 for gasoline, compared to \$1,705 for urban households.

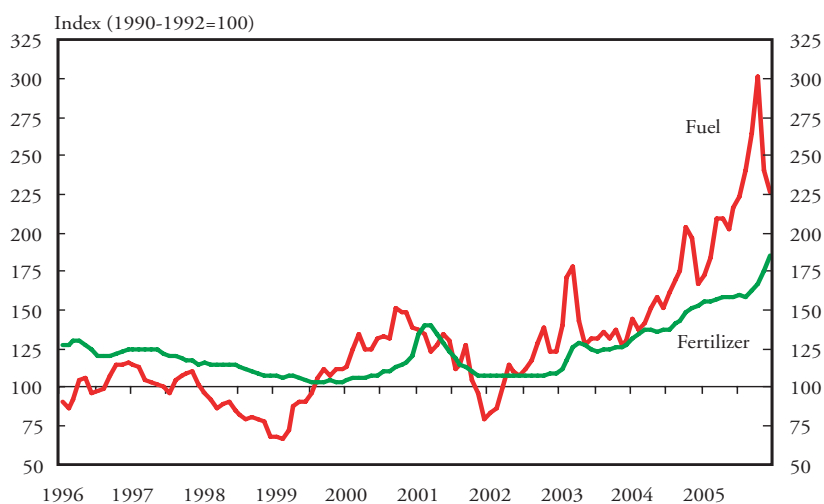
Higher energy prices hurt the rural economy, but they can also fuel new investment opportunities in rural America. Bio-fuels production has surged recently with the rapid expansion of ethanol and bio-diesel, a fuel produced mainly from soybeans. Last year, the U.S. produced more than 4 billion gallons of ethanol, up from 1.7 billion gallons in 2001. According to the National Bio-diesel Board, bio-diesel production expanded from roughly 5 million gallons in 2001 to over 25 million last year. Higher oil prices are making bio-fuels production

Crop revenues may not be quite so resilient. Two years of bumper crops in the U.S. market have depressed prices from the highs posted in 2004. Corn and soybean prices are expected to fall well below year-ago levels (Table 1). While soybean prices are expected to remain above their historical levels, corn prices are expected to stay below theirs. Wheat prices could remain near 2005 levels as drought and other production-related issues have trimmed global grain inventories. Lower crop prices in 2005 led to a surge in government payments. If prices remain low, government payments this year will probably remain near record levels.

ENERGY'S IMPACT

The biggest risk to a robust rural economy in 2006 will be high energy prices. Rural businesses are already feeling the pinch of higher prices. In the farm sector, higher energy prices have pushed up input prices substantially. Last year, farmers paid 40% to 50% more for fuel than in the year before (Chart 3).

Chart 3
Prices Paid by Farmers



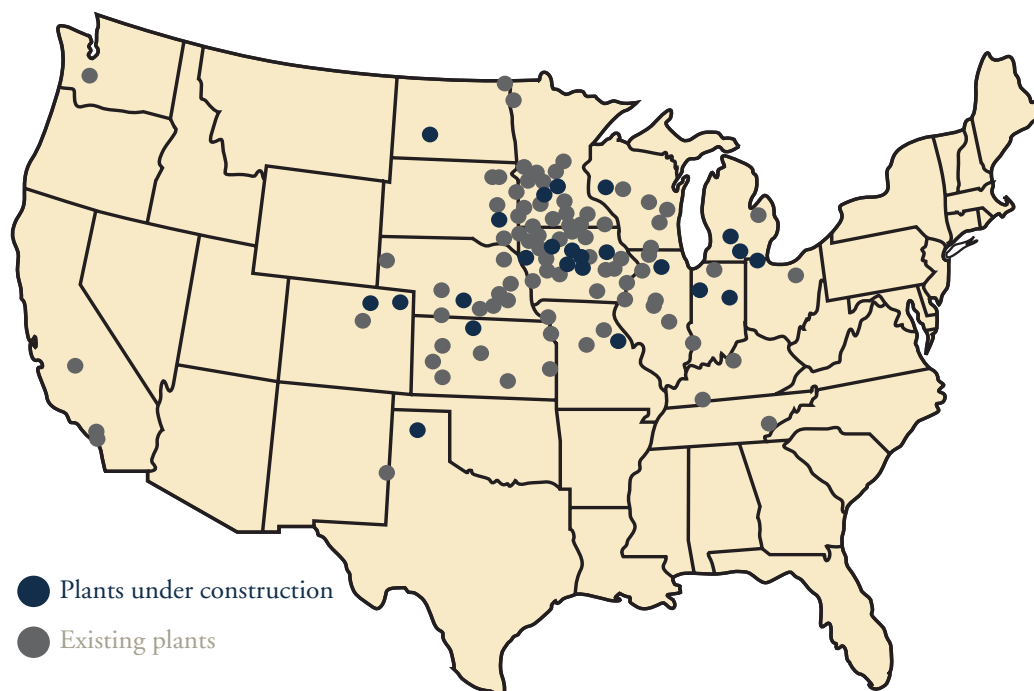
Source: USDA

more profitable and fueling new investments in bio-fuel plants, many in rural America. As of November 2005, 24 ethanol plants were under construction with another 56 proposed plants for bio-diesel production (Map 1). These investments not only boost nonfarm economic activities, they also provide new market opportunities for farm products. For example, according to USDA, the annual amount of corn used to produce fuel has increased from less than 500 million bushels before 1995 to more than 1.5 billion bushels last year.

The resilient rural economy overcame 2005's natural disasters and high energy prices to post another prosperous year. Main Streets posted strong job growth, and robust farm incomes underpinned a strengthening rural economy. The stage is set for another year of economic growth in 2006.

High energy prices pose the biggest risk to the rural economy. Rural businesses and farmers will pay higher input costs, and rural households will spend more for gas. Still, higher energy prices may fuel new investments and a new generation of market opportunities in rural America.

Map 1
Ethanol Production Plants
(as of November 18, 2005)



Source: American Coalition for Ethanol

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