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The Main Street _____ Economist *Commentary on the rural economy*



Will the Rural Economy Rebound with the Rest of the Nation?

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As the U.S. economy slipped into recession in 2001, an already lackluster rural economy lost even more steam. Since 1995, job growth in rural areas has trailed growth in metro areas. But in the wake of last year's terrorist attacks, national recession, and falling food demand, job rolls in many parts of rural America have not only slowed but contracted. Meanwhile, commodity prices have only recently begun to turn around. As a result, farm incomes continue to rely on large payments from Uncle Sam.

With the U.S. economy now in recession, the demand for most rural products—farm and nonfarm alike—has stalled. Many economic analysts expect the U.S. economy to turn around in 2002. But, are the prospects of a rural recovery as bright as the rest of the nation? Are both the Main Street and farm segments of the rural economy positioned to recover?



A Main Street recession in 2001

The terrorist attacks of September 11 deepened the recession in the U.S. economy, and the Main Street economy followed suit. The manufacturing sector, which limped into 2001, slumped throughout the year. Service activity, while healthy, was not strong enough to keep Main Streets out of a recession.

Entering 2001, rural manufacturers were already finding it hard to maintain job rolls. In fact, job rolls in rural factories shrank throughout the year and by September 11 rural manufacturing jobs were 5.5% below a year earlier (Chart 1). After the terrorist attacks, layoff announcements only intensified the contraction in manufacturing activity.

As rural manufacturing contracted, other rural economic activity slowed. Service industries, which account for the largest share of rural jobs, entered the year adding jobs at a 4% clip. By October, that growth rate had been cut in half. As early as April, merchants, which account for the second largest portion of rural jobs, were struggling to keep jobs at year-ago levels. Despite lower interest rates, construction activity also slowed in 2001. Slowing activity led to sliding construction job gains throughout the year.

Shrinking demand for rural products and services left the Main Street economy struggling to maintain job levels of a year ago. In October, employment fell to year-ago levels. As layoff announcements mounted, the rural nonseasonally adjusted unemployment rate rose sharply to 4.9% in October, compared with 4.7% in the nation as a whole, and layoffs are continuing.

Will Main Streets recover in 2002?

The current downturn on Main Street follows a history of rural economies traveling the same path as the rest of the nation. With many analysts expecting a recovery in the U.S. economy in 2002, Main Street should also recover in 2002, if history is a reliable guide.

Many economic analysts forecast an end to the recession soon after the first

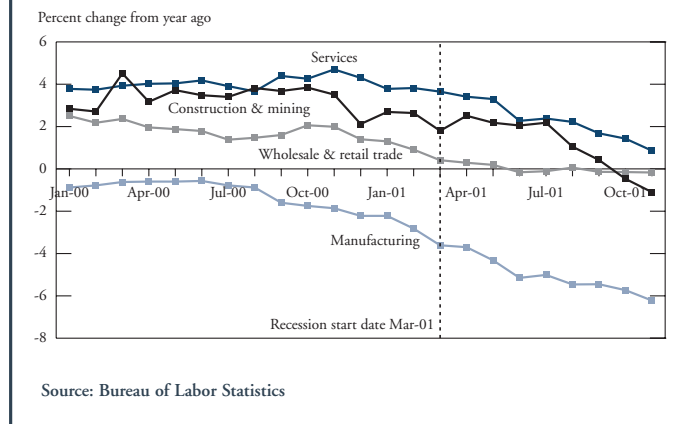
quarter. A consensus survey of economic forecasters reported that the annual rate of growth in GDP would turn positive in the first quarter of 2002 and continue to grow.¹ Over 90% of these same forecasters expect the recession to end by June 2002.

Assuming the nation's recovery materializes, can rural areas keep pace with the rest of the nation? Contrary to expectations, rural areas have actually led the U.S. out of recession several times in the past. The Main Street economy actually grew faster than the nation in three of the last five recoveries since 1970, the most recent coming after the 1991 recession. But the forces that propelled rural economies into a leadership role in those recessions do not appear to be in place this time around.

Rural places paced economic recoveries in the 1970s and after the 1991 recession. The twin forces that allowed rural areas to pace a U.S. recovery from those recessions—stronger service-based activity and a softer manufacturing slowdown—are currently missing. Job cuts have been deeper for rural manufacturers. Rural service firms are still adding jobs, but the gains are not as strong as in the last recession and may not be able to overcome job losses in manufacturing.

Whether service activity in rural areas can continue to outpace metro areas is also open to question. Traditional engines of rural service growth could potentially face stiff challenges in the current recession. Over the past decade, rural locations rich in natural amenities—particularly lakes, streams, and mountain vistas—have paced rural employment growth. These recreation and retirement destinations continue to enjoy the fastest rate of employment growth in the new century. By depending more on

Chart 1
Rural Job Growth by Industry

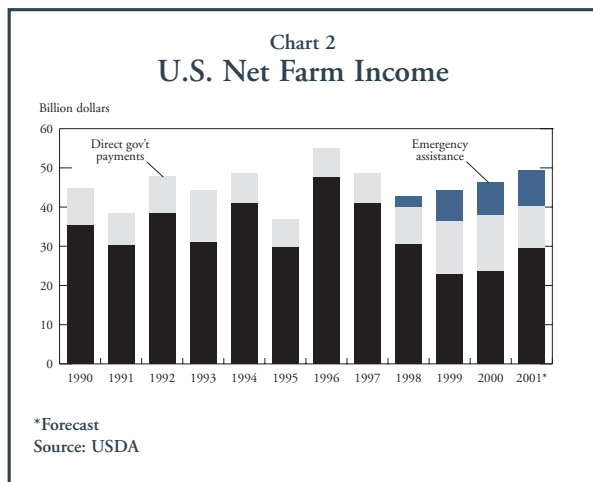


tourist dollars than other rural areas, a slowdown in travel limits their overall economic activity. These locations are facing serious difficulties in the current recession.

Are farms poised to rebound?

While the Main Street economy faced recession in 2001, the farm economy was beginning to shake off its recent slump. Another round of government emergency payments and higher market receipts for livestock and crops boosted farm incomes in 2001, improving the farm balance sheet. Heading into 2002, food supplies are expected to shrink, positioning commodity markets for a possible price rally. The strength of the rally depends on the U.S. and global economies emerging from recession to boost food and agricultural product demand.

Farm income rebounded in 2001 with another boost from Uncle Sam and higher market-based incomes (Chart 2). USDA expects U.S. net farm income, a broad measure that accounts for inventory swings and depreciation, to rise 6.5% to \$49.4 billion in 2001, its highest level since the banner year of 1996. Unlike 1996, however, more than a third of net farm income in 2001 came from government payments. Congress passed another round of emergency payments, bringing the total to \$9.1 billion, slightly higher than the \$8.5 billion in 2000. The rise in emergency payments offset a decline in farm bill payments



boosted land values. By the end of the year, higher supplies and waning demand from the economic recession weighed heavily on farm commodity prices. Both smaller supplies and a recovery in food demand will probably be needed to boost prices in 2002.

A potential price rally in 2002?

Heading into 2002, food inventories are comparatively small. Small food supplies leave

the agricultural commodity markets poised for a potential price rally. But the extent of that rally will depend on how quickly the U.S. and global economies emerge from recession—and how quickly new markets for farm products develop.

Lower food supplies position commodity markets for a potential price rally. For the second straight year, world grain consumption outstripped world production leaving inventories heading into 2002 well below a year ago. U.S. beef and pork production are also expected to drop roughly 4% in the first half of 2002.

While commodity markets may be positioned for a price rally, demand concerns make a recovery uncertain. Following September 11, restaurant demand plummeted. Export activity has declined with the growing global recession and Mad Cow disease fears emerging in Japan. New demand for nonfood products, such as ethanol, needs to emerge to help spark a farm recovery.

The immediate impact of the terrorist attacks on the agricultural economy was the stoppage of airline travel that brought about a dramatic decline in restaurant sales. As people stayed home and businesses cut back on corporate travel, September restaurant sales plummeted 9.2%, placing downward pressure on livestock prices, especially high-end meats. Although restaurant sales have rebounded somewhat, they have failed to return to pre-attack levels. A slow recovery in restaurant sales could limit domestic food demand in the year ahead.

In addition to weak domestic demand, slower export activity, especially to Asia, could limit the demand for U.S. agricultural products in the year ahead. Since the second quarter of 2001, export growth has slowed dramatically as agricultural exports to Asia, which account for roughly 40% of U.S. agricultural exports, fell 3.5% below year-ago levels in the third quarter. In 2002, export activity to Asia may not rebound strongly. The Japanese economy remains especially weak, and the presence of Mad Cow disease is limiting Japanese beef consumption, shrinking the largest market for U.S. agricultural exports.

With the prospect of lagging food demand in 2002, new sources of demand for agricultural products, such as ethanol, may be needed to boost commodity markets. Last year, the EPA rejected California's request to be waived from federal standards on oxygenates in gasoline, thus opening up a whole new market for U.S. corn. Ethanol production jumped 41% in 2001 and is expected to double by 2005. The additional 1 billion bushels of corn needed to accommodate the new capacity will boost demand and help support prices.

Summary

The U.S. recession spread to a weak rural economy in 2001, where shrinking demand for rural products caused a contraction in rural manufacturing activity. Healthy service activity has not been strong enough to boost overall job rolls on Main Street. Falling demand for farm products limited a rebound in the farm economy. Despite the recession, improved market earnings and big government payments stabilized farm balance sheets. Entering 2002, food supplies are comparatively lean, setting the stage for a possible rally in commodity prices.

A full rural rebound, however, will depend on increasing demand for existing products and reaching new outlets beyond traditional food markets.

¹ GDP forecasts in this article are based on the *Blue Chip Economic Indicators*, Jan. 10, 2002.

emerging from the 1996 farm bill.

Market-based farm income rose to \$29.4 billion, paced by a rebound in livestock markets during the first half of the year. Smaller livestock supplies at the beginning of 2001 boosted prices and led to a 9% jump in livestock cash receipts. Though not as strong as livestock, crop receipts managed a 3% gain to \$97 billion in 2001.

Bigger government payments and larger farm cash receipts supported rising land values in 2001. The district's quarterly survey of farm bankers reported a buoyant 4% gain in land values during the year ending in September. Land value gains appeared to slow throughout the year, though, and the weaker growth rate may be driven by diminished nonfarm demand for agricultural land due to the recession.

Rising land values and farm income led to a healthy farm balance sheet as farmers used income gains to pay off existing debt. Farm business assets rose almost 3% in 2001, paced by growth in farm real estate assets. Cheaper borrowing costs due to lower interest rates and tax incentives to convert nondeductible personal property to farm business property pushed up farm debt. Still, the farm sector debt-to-asset ratio remained well below historical levels.

Overall, higher commodity prices and increased government payments have produced financial stability in the farm economy. Debt-to-asset ratios remain low as rising incomes from slightly higher commodity prices and government payments

Survey of Agricultural Credit Conditions

Federal Reserve Bank of Kansas City

September 30, 2001

Highlights from the third quarter survey¹

- Gains in district farmland values remained steady in the third quarter of 2001. District cropland values edged up 0.6 % while district rangeland values rose 1.1%. Nebraska and Oklahoma posted solid gains in the quarter while gains in the Mountain states leveled off, hinting that nonfarm demand may have slowed with the national economy. Compared to the previous year, district cropland and rangeland values are up 4 and 5%, respectively.
- The district farm commodity price index dropped in the third quarter. Prices for wheat, soybeans, and livestock softened while corn prices rose. The index, however, remains above year-ago levels, and net farm income is expected to rise above 2000.
- Farm credit conditions revealed a few bright spots. Loan repayment rates rebounded during the quarter, and bankers reported fewer requests for loan renewals or extensions. In addition, bankers report ample funds available for farm loans and interest rates remain low. Demand for farm loans, however, was noticeably below the previous two years.
- Farm interest rates continued to decline in the third quarter. At the end of the quarter, interest rates on new farm loans averaged 8.61% for operating loans, 8.43% for feeder cattle loans, 8.45% for intermediate-term loans, and 7.96% for real estate loans. Since September, interest rates in national money markets have fallen.

Note: 276 bankers responded to the third quarter survey.

¹ Please refer questions to Kendall McDaniel, associate economist, at 816-881-2291 or kendall.l.mcdaniel@kc.frb.org.

Farm Real Estate Values September 30, 2001 (Average value per acre by reporting banks)

	Nonirrigated	Irrigated	Rangeland
Kansas	\$653	\$1,093	\$388
Missouri	999	1,203	659
Nebraska	882	1,465	369
Oklahoma	535	777	384
Mountain states*	361	1,131	249
Tenth District	\$712	\$1,215	\$394
Percent change from:			
Last quarter+	0.62	0.57	1.12
Year ago+	4.01	4.06	5.15
Market high	-15.68	-15.65	-3.90
Market low	79.71	78.61	136.14

* Colorado, New Mexico, and Wyoming combined.

+ Percentage changes are calculated using responses only from those banks reporting in both the past and the current quarter.

Source: Federal Reserve Bank of Kansas City

Selected Measures of Credit Conditions at Tenth District Agricultural Banks

	Loan demand (index)+	Loan Fund availability (index)+	Loan repayment rates (index)+	Average renewals or extensions (index)+	Loan-to-deposit ratio* (percent)	District farm commodity price index (1980=100)
1999						
Jan.–Mar.	105	113	56	143	65.7	88.0
Apr.–June	107	107	71	127	66.5	89.9
July–Sept.	103	90	74	126	67.7	89.5
Oct.–Dec.	100	99	86	115	67.7	94.1
2000						
Jan.–Mar.	107	95	92	108	67.1	100.6
Apr.–June	112	78	86	108	70.4	99.5
July–Sept.	103	85	84	112	70.8	93.0
Oct.–Dec.	106	90	82	120	70.9	102.6
2001						
Jan.–Mar.	111	106	78	123	70.5	105.3
Apr.–June	111	100	76	120	70.4	102.7
July–Sept.	98	116	83	115	71.2	99.7

* At end of period.

+ Bankers responded to each item by indicating whether conditions during the current quarter were higher than, lower than, or the same as in the year-earlier period. The index numbers are computed by subtracting the percent of bankers that responded "lower" from the percent that responded "higher" and adding 100.

Source: Federal Reserve Bank of Kansas City