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Prospects for a rural recovery

by Jason Henderson, Vice President and Omaha Branch Executive, Federal Reserve Bank of Kansas City – Omaha Branch

Over the course of the recent recession, rural economies have held up better than their metro peers, thanks to strong rural economic gains early in the downturn. Even so, since 2007 rural communities have endured the steepest and longest economic contraction since the Great Depression. With the worst now over, prospects for a rural recovery appear to rest on rebounding consumer demand. But a jobless recovery may keep the lid on domestic demand, making stronger export activity another critical factor for rural prosperity.

Stronger demand and exports can reverse the cyclical downturns experienced during the recession. But many of the long-term structural challenges facing rural America remain: Out-migration is growing, industries are consolidating, and access to financial capital remains tight. In short, the long-term health of rural America in the 21st century will rest on developing policies that focus on amenity-based development, entrepreneurship, and innovation.

The "great recession" in rural America

Many rural economies were able to deflect the initial blows of the recession. But by the end of 2008, rural America was confronting what some economists are now calling the "Great Recession." The combination of a deep recession and a financial market crisis brought sharp economic contractions to Main Streets. Still, strong gains at the start of the recession allowed rural economies to perform better than their metro counterparts.

Throughout most of 2008, rural economies were able to keep employment above previous-year levels. Toward the end of the year, however, sharp economic contractions led to steep job losses. Rural economies outperformed their metro peers, with job losses of 0.2 percent, compared to metro jobs losses approaching 0.4 percent. But as the recession extended into 2009, rural communities began to feel the full force of recession and rural job losses escalated (Chart 1).

Despite the mounting job losses, rural communities across a large cross section of the country have been able to outperform their metro counterparts. In regions west of the Mississippi River and in the New England/Middle Atlantic region, rural communities have sustained fewer job losses than neighboring metro communities (Chart 2). In the West South Central Region (Texas, Oklahoma, Arkansas, and Louisiana), rural communities posted much stronger job gains than in the region's metro areas since the start of the recession.

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Handbook updates

For those of you subscribing to the handbook, the following updates are included.

Estimated Costs of Crop Production in Iowa - 2010 – A1-20 (12 pages)

Corn and Soybean Price Basis – A2-40 (3 pages)

Grain Price Options Basics – A2-66 (6 pages)

Options Tools to Reduce Price Risk – A2-67 (6 pages)

Options Tool to Enhance Price – A2-68 (4 pages)

Suggested Closing Inventory Prices For 2009 Records – C1-40 (2 pages)

Please add these files to your handbook and remove the out-of-date material.

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Inside . . .

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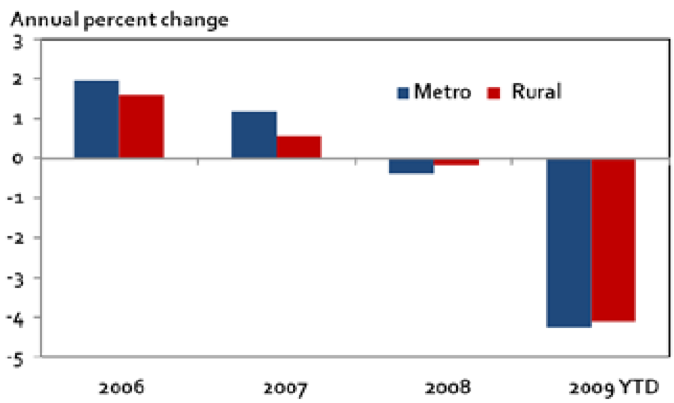
Chart 1. U.S. Employment Growth by Metro and Rural Counties



Source: Bureau of Labor Statistics
Year-to-date data through September 2009

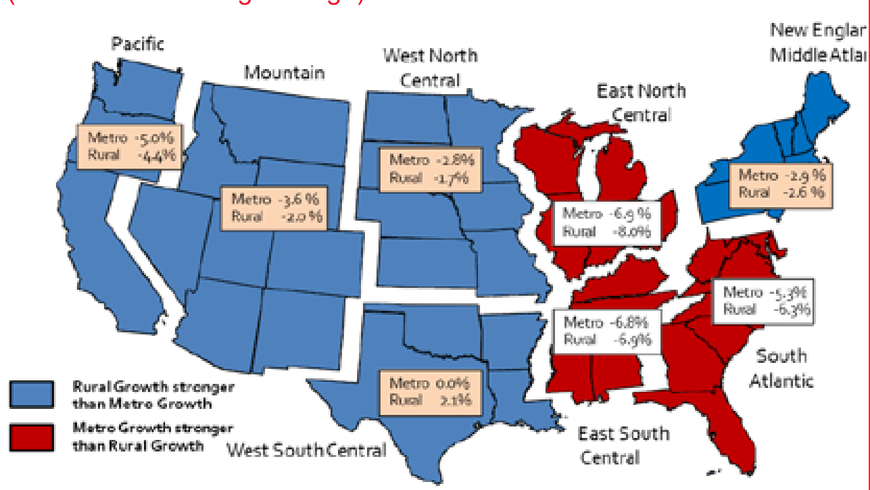
The relative strength of the rural economy has been fueled in part by its large concentration of commodity-based industries. The spike in commodity prices during the first half of 2008 set the stage for robust rural economic growth in many areas. Rising commodity prices also spurred economic gains in farm-dependent regions, as farmers increased their purchases of goods and services. Energy and mining-dependent regions also enjoyed stronger economic gains, as energy companies increased production, boosting the demand for energy-related goods and services.

The housing crisis was also less severe in most rural areas. The earlier boom in rural housing, in terms of over-building and rising prices, was smaller than across the nation. Moreover, rural areas had less exposure to subprime loans and foreclosures. Consequently, rural home prices have dropped less than in metro areas. According to the Federal Housing Finance Agency (FHFA), rural home prices, unlike metro home prices, remained above year-ago levels through most of 2008. By the second quarter of 2009, rural prices were still only 1.6 percent below year-ago levels, compared to 5.9 percent below in metro areas.

The financial market turmoil was also blunted in rural economies. Structural differences between rural and metro financial service industries gave rural areas less exposure to investment bank activities. For example, securities, commodity contracts, and investments accounted for less than 10 percent of earnings at rural financial institutions, compared to a third for metro institutions. Until the financial crisis spread beyond Wall Street, rural financial service firms avoided the high losses of jobs suffered in metro areas. Agricultural banks (predominantly smaller commercial banks in rural communities) continue to post a stronger return on assets than other commercial banks. According to the Federal Deposit Insurance Corporation (FDIC), return on assets at rural agricultural banks reached 0.79 percent in the second quarter of 2009, compared to -0.12 percent for commercial banks as a whole.

Weakness in rural financial markets has intensified, however, and commercial banks have responded by tightening credit standards on a wide variety of household and business loans. By the second quarter of 2009, almost all commercial banks reported raising credit standards for residential and commercial real estate loans and for C&I loans. In addition to raising credit standards, banks have also raised collateral requirements on loan activity. To further reduce risk, banks have also shortened the maturity on business loans. Over the past year, the maturity of farm loans has shrunk from 15 to 11 months. While the financial crisis has eased and fewer banks are reporting tightening credit standards, risks remain. For example, delinquency rates for commercial real estate loans have climbed from 4.2 to 7.9 percent since mid-2008.

Chart 2. U.S. Employment Growth, Sept. 2007 to Sept. 2009 (three-month moving average)



Calculations based on Bureau of Labor Statistics, LAUS data

The near-term rebound hinges on demand

As the recession and financial crisis deepened, consumer demand fell sharply. Thus, recovery will hinge on rebounding consumer demand. According to the Census Bureau, retail spending in the U.S. has fallen roughly 7 percent below 2007 levels. While spending levels have solidified in 2009, retailers are less confident about resurgent demand heading into the Christmas shopping season. Moreover, the prospects of another jobless recovery, attended by weak job growth and limited income gains, could restrain consumer spending.

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A clear example comes from consumer spending on proteins. Historically, U.S. per capita expenditures on meat and milk products have tended to decline during recessions and then rebound during recoveries. However, during the jobless recoveries following the 1990 and 2001 recessions, per capita U.S. protein expenditures bucked historical trends and posted further declines a year after both recessions ended. Moreover, these expenditures have fallen more sharply during the recent recession. Together, these trends suggest a weaker rebound in demand for this recovery.

On the positive side, consumer spending appears to have fallen less dramatically in rural areas than in metro areas. A handful of states reports spending data at the county level. Rural retail sales in Washington, North Carolina, and Vermont have fallen less dramatically in metro areas (Chart 3). In Kansas and Nebraska, rural sales have actually expanded over the past year, in contrast to the state's declining metro sales. If a jobless recovery dampens national consumer spending, such cross winds in rural America may boost consumer spending on Main Streets.

With such anemic expectations for domestic demand, exports will be crucial to rural prosperity. Improvements in the U.S. trade balance have underpinned the U.S. economy over the past year. In 2008, economic strength in developing countries spurred robust demand and record prices for food and energy commodities. Toward the end of the year, weakening global economies clipped the foreign demand. But heading into 2010, with stronger economic gains, especially in emerging countries, opportunities for stronger rural export activity may emerge.

For rural communities, processed food products appear to be a relatively bright spot. In 2007 and 2008 manufactured food exports rose 20-25 percent, well above gains in other manufacturing sectors. In 2009, while manufactured food exports dropped roughly 10 percent, other manufactured exports fell more sharply. With heavy concentrations of food processing activity in rural communities, the strength in manufactured food exports is one indicator of relatively stronger export activity for rural communities. The prospects of stronger exports will be driven in part by more robust growth in foreign economies and a lower value of the dollar that would make U.S. goods more affordable in foreign countries.

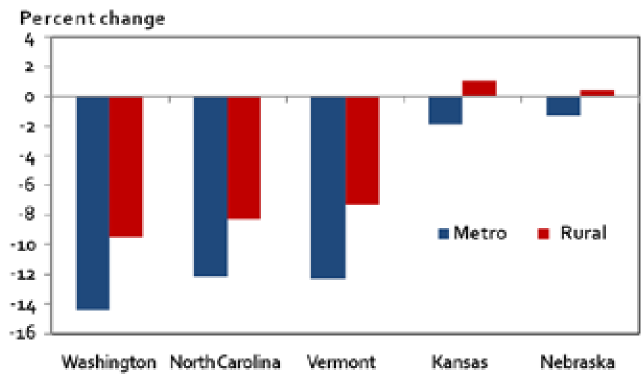
Long-term structural challenges

Rural economies have weathered the recession and financial crisis better than their metro peers. But recessions are cyclical downturns in economic activity. The long-term structural challenges to rural prosperity—outmigration, consolidation, and access to financial capital—will continue to threaten rural prosperity. Going forward, the continued focus on entrepreneurship, innovation, and amenities-driven growth can help offset these challenges.

Outmigration has been a persistent challenge for rural America. A substantial portion of the Baby Boom generation born between 1960 and 1964 and Gen X'ers born from 1965 to 1969 typically left rural communities for urban areas after graduating from high school and college. In the Kansas City Federal Reserve District, though, trends are showing that middle-aged families are returning to rural communities (Chart 4). As baby boomers and Gen X'ers reach age 30, their numbers in rural communities begin to rise, implying a net immigration of these population cohorts.

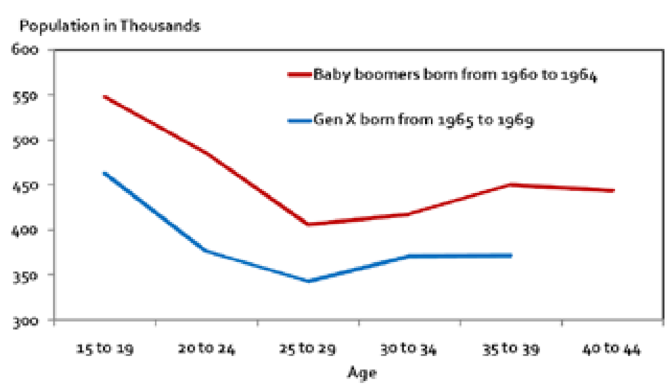
People still move to places with job opportunities, but research is finding that people are increasingly relocating to communities that offer a high quality of life. As people age, their location choices change. Young adults prefer to live in communities with robust business environments, while older adults prefer metro and nonmetro areas that offer high levels of consumer amenities. While a robust business environment is crucial, so is a community's ability to offer personal con-

Chart 3. Retail Sales Growth: 2007 to 2009



Year-to-date through second quarter retail sales obtained from various department of revenues

Chart 4. Rural Baby Boomer and Gen X Population Cohorts in Kansas City Federal Reserve District



Calculations based on Census Bureau data. Rural areas are based on nonmetro county definitions. The Kansas City Federal Reserve District includes Colorado, Kansas, Nebraska, Oklahoma, Wyoming, and portions of Missouri and New Mexico.

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sumption amenities, such as education and health services, personal services and recreational amenities.

Consolidation is a second structural challenge facing rural communities. Historically, rising fixed costs and economies of scale in agriculture drove farms to consolidate into larger enterprises. At first, consolidation freed local labor for smaller nonfarm enterprises in rural communities, but it also freed local labor to migrate out of rural America. Over time, the drive for efficiency and economies of scale in industrialized commodity industries also led to consolidation in rural nonfarm enterprises. But rural communities struggle to provide the support network of industries that larger enterprises need to succeed.

Fixed costs have risen quite rapidly in recent years, exacerbating the challenge of consolidation in rural economies. High fixed costs give larger firms a competitive advantage as these firms are able to spread the costs across more production units. The recent surge in farmland values is one example of rising fixed costs of production. Since 2004, farmland values have risen almost 60 percent. As farmland values rise, so do the benefits of larger farm operations.

In addition, the recession and financial crisis have also increased the desire to strengthen the regulation of business and commerce. Regulatory costs are another source of fixed costs for businesses, and unless exempted, they place higher burdens on small operations that are unable to spread these costs across larger production units.

Recent policy developments have touted using entrepreneurship and innovation to counteract the trends of consolidation and rebuild the competitiveness of rural economies. A growing body of research documents the economic benefits that flow to small rural communities from entrepreneurship and innovation. The recession has likely exacerbated the structural challenges that entrepreneurship policy was designed to address. Thus, entrepreneurship and innovation may become even more important to the economic revitalization of rural America.

Access to financial capital is a third structural challenge for rural communities. Entrepreneurs need access to financial capital to fund the innovations and investments critical to building strong, viable rural businesses. Traditionally, rural community banks have been the primary source of capital to rural businesses. Over the past decade, as nonbank financial markets developed, the growth of core deposits at commercial banks slowed. To finance their loans, many banks tapped higher-cost wholesale market funds.

Surprisingly, the financial crisis has actually increased the level of core deposits in rural community banks. But is this level sustainable? As investors have searched for safe haven investments, they have placed money in FDIC insured accounts at commercial banks. As a result, domestic deposits have risen 3.0 percent over the past year. Rural bankers continue to report they have funds available for loans that meet qualification standards. But will these funds remain in rural commercial banks as economic and financial conditions improve? As the risks in financial markets abate, investors may pull money out of "safe haven" accounts in search of higher returns.

The financial crisis has boosted funds available for debt capital, but has slashed equity capital funds. According to the National Venture Capital Association, in the first half of 2009 the money invested in venture capital deals was half that invested in the first half of 2008. But many venture capitalists still view rural places as "fly over" states or regions. With the challenges of financial access to rural communities basically changed, the proposed policies to support rural economic development should probably remain the same.

Summary

Strong commodity markets in 2008 helped cushion rural America from the initial blows of the recession and financial market crisis. But rural economies were not immune to the economic downturn and by 2009 were struggling with mounting job losses and weakening economies.

A rural recovery hinges on a rebound in the demand for rural products and services. While the prospects of robust domestic demand could be limited by a jobless recovery, stronger foreign growth could spur rural export activity. Rural businesses will need to focus on producing goods and services targeted to meet the tastes and preferences of global consumers.

But as rural economies emerge from the "Great Recession," they still face the persistent challenges of outmigration, consolidation, and access to financial capital. The continued focus on entrepreneurship, innovation, and amenity-based growth could help revitalize rural communities.

Originally published in Issue V, 2009 of the Main Street Economist, a publication of the Federal Reserve Bank of Kansas City.

Worker, homeownership, and business assistance act of 2009

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One of the shortest tax bills in modern time, containing only 18 provisions, passed the Congress and was signed into law on Nov. 6, 2009. Not withstanding its brevity, the legislation contains some very significant provisions for workers, homeowners and businesses.

Credits for home ownership

Under the Housing Assistance Tax Act of 2008, a taxpayer who was a first-time home buyer was eligible for a 10-percent (of the purchase price) refundable credit equal to the lesser of $7,500 ($3,750 for a married taxpayer filing separately) or 10 percent of the purchase price of a principal residence. The credit phased out for individual taxpayers with modified adjusted gross income in the year of purchase between $150,000 and $170,000 for joint filers, $75,000 to $95,000 for those married filing separately. The credit was recaptured over 15-years with no interest charge beginning in the second taxable year after the taxable year in which the home was purchased. In the event the taxpayer sold the home or the home ceased to be used as the principal residence of the taxpayer or the taxpayer's spouse, before complete repayment of the credit, any remaining credit amount was due on the return for the year the home was sold or ceased to be used as the principal residence. The provision was effective for qualifying home purchases on or after April 9, 2008, and before Dec. 1, 2009.

In 2009, Congress passed and the President signed the American Recovery and Reinvestment Act of 2009 which increased the maximum 10 percent first-time home buyer tax credit from $7,500 to $8,000. The Act also eliminated any required repayment after 36 months in the home for any credit allowed for the purchase of a principal residence after Dec. 31, 2008 and before Dec. 1, 2009, the date set for termination of the first-time home buyer credit program. The phase-out continued at the same levels for the credit authorized in 2009.

The legislation signed on Nov. 6, 2009 extended the $8,000 tax credit for first-time home buyers through April 30, 2010. The new legislation also authorizes a reduced credit of $6,500 for individuals (and, if married, the individual's spouse) who have owned and used the same residence as their principal residence for any five consecutive-year period during the eight year period ending on the date of purchase of a subsequent principal residence. The individual or individuals are considered to be a first-time home buyer. The income phase-out is changed from $75,000/ $150,000 to $125,000/ $225,000. The new law specifies that the purchase price of the residence cannot exceed $800,000 and the purchaser must have attained the age of 18-years unless the taxpayer is married and one of the spouses meets the age requirement. The new rules also provide that the residence cannot be acquired from the spouse's family by gift or inheritance (where the income tax basis carries over), in addition to the related party limitations in the earlier enactment. Special rules apply to military personnel.

Five-year carryback of net operating losses

The American Recovery and Reinvestment Act of 2009 provided for a three, four or five year carryback of 2008 net operating losses (the choice was up to the taxpayer) but only for qualified small businesses with average gross receipts of $15 million or less.

Under the legislation signed into law on Nov. 6, 2009, law, for net operating losses for a taxable year ending after Dec. 31, 2007 and beginning before Jan. 1, 2010 (basically 2008 and 2009), the net operating loss by election can be carried back as many as five years and is open to all businesses (except for those receiving funds under the Troubled Asset Relief Program—TARP—if the federal government acquired or had the right to acquire an equity interest in the firm). However, an election may be made for only one taxable year. For elections to carry back the NOL to the fifth taxable year preceding the taxable year of the loss, the amount of NOL is limited to 50 percent of the taxpayer's taxable income for all except for elections by small businesses.

These provisions do not apply to farming losse. Farming losses have been eligible for five year carryback since 1998.

Failure to file penalty for S corporation and partnership returns

The legislation raises the penalty for failure to file an S corporation or partnership return from $89 to $195 per shareholder or partner per month for a maximum of 12 months. The change is effective for tax years beginning after Dec. 31. 2009.

Mandatory e-filing

Tax return preparers, except for those expecting to file 10 or fewer individual income tax returns during the calendar year, are required to e-file the returns, effective for returns filed after 2010. This applies to taxes imposed by subtitle A of the Internal Revenue Code (income tax).

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FUTA surtax

The new law extends the 0.2 percent FUTA surtax through 2010 and for the first six months of calendar year 2011. Thus, the 6.2 percent rate will continue into the first half of 2011.

Unemployment benefits

The legislation provides 14 additional weeks of unemployment benefits to all unemployed workers who exhaust their benefits and six additional weeks of benefits to unemployed workers who exhaust their benefits in states with 8.5 percent unemployment or more.

**Reprinted with permission from the November 20, 2009 issue of Agricultural Law Digest, Agricultural Law Press Publications, Brownsville, Oregon. Footnotes not included.*

Updates, continued from page 1

Internet Updates

The following updates have been added on www.extension.iastate.edu/agdm.

Understanding Cash Flow Analysis – C3-14 (4 pages)

Understanding Net Worth – C3-19 (3 pages)

Understanding Profitability – C3-24 (5 pages)

Building Equity in Your Farm – C3-60 (3 pages)

Obtaining a Business Loan – C5-95 (4 pages)

Forming a Viable Project Committee and Holding Successful Meetings – C5-110 (3 pages)

Top Management and Key Personnel Positions in a Business – C5-111 (2 pages)

Designing Successful Business Teams – C5-114 (2 pages)

Solving Conflicts between Business Associates – C5-115 (2 pages)

Improving Business Communication Skills – C5-116 (2 pages)

Keys to Successful Planning for Strengthening your Business – C5-150 (2 pages)

Assessing Agricultural Processing Business Opportunities – C5-230 (5 pages)

Decision Tools and Current Profitability

The following tools have been added or updated on www.extension.iastate.edu/agdm.

Season Average Price Calculator – A2-15

Projected ACRE Payments for Iowa Crops – A1-33

Corn Profitability – A1-85

Soybean Profitability – A1-86

Ethanol Profitability – D1-10

Biodiesel Profitability – D1-15

Returns for Farrow-to-Finish - B1-30

Returns for Weaned Pigs - B1-33

Returns for Steer Calves - B1-35

Returns for Yearling Steers - B1-35