

## The 2009 Economic Landscape

# How Long Can Energy and Agriculture Boost the Nation's Midsection?

The energy and agricultural sectors are important economic drivers for states in the center of the country. Extending from the oil patch of **Texas, Louisiana, Arkansas, and Oklahoma**, northward through the plains states and eastward to the Corn Belt, the states in the nation's midsection are not only rich in land and other natural resources, but also tend to rely heavily on these resources as drivers of economic activity. Booming commodity prices during the middle years of this decade have helped buoy the economies of these states, even while the rest of the country was moving toward recession. However, recent declines in many of these same commodity prices raise concerns about wider economic repercussions for these regions as the U.S. recession continues. This article describes how commodity industries drive the economies of the nation's midsection and evaluates their outlook after the commodity price boom.

### Energy and Agriculture Regions Do Not Always Follow the U.S. Business Cycle

Energy prices can have a profound effect on the national economy. In fact, since World War II, nearly all recessions were preceded by oil price shocks. These shocks adversely affect businesses and consumers, causing economic growth to slow. For example, around the time of the Iranian revolution in 1979, oil prices doubled within a year, contributing to the 1980 and 1981–82 national recessions. Similarly, the 1990–91 recession was precipitated, in part, by another doubling of oil prices in the months following the invasion of Kuwait and leading up to the first Gulf War.

Unlike the rest of the nation, oil-patch states tend to benefit from higher oil prices. In the early 1980s and early 1990s, higher oil prices helped these states grow even during national recessions. However, when prices collapsed during the mid-1980s, oil-patch states fell into their own regional recession. The lingering effects of the “oil bust” resulted in falling real incomes in the region. The subsequent loss of jobs, income, and output contributed to house price declines that created turmoil

in residential real estate markets and led to hundreds of bank failures.<sup>1</sup>

Like the energy sector, agriculture does not move in perfect tandem with the national economy, though influences from U.S. and global trends can be strong. For example, global economic conditions affect the demand for food, which helps drive agricultural commodity prices. In addition, large interest rate movements can have a profound effect on farmland prices. For example, in the early 1970s, strong demand for farm commodities caused farm incomes to rise rapidly. When combined with negative real interest rates, this favorable environment caused sharp increases in the value of farmland. In the late 1970s, however, soaring interest rates and changing conditions in global supply and demand brought the boom period to an end. The result was a significant decline in real farm incomes, a rapid and long-lasting decline in farmland values, and hundreds of farm bank failures in the 1980s.<sup>2</sup>

### Energy and Agriculture Boomed through Mid-Year 2008

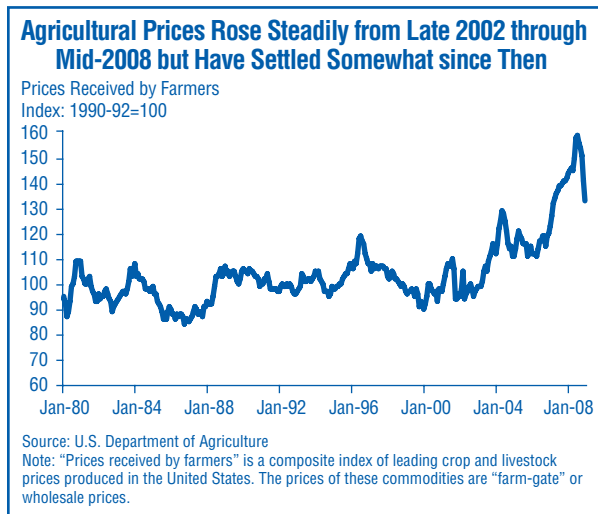
Current energy and agricultural conditions have, for the most part, played out independently of national economic trends. Despite the weakening U.S. economy, the health of the energy and agricultural industries has been very strong over the past several years. Crude oil prices quadrupled in dollar terms between 2003 and mid-2008, setting the trend for overall energy prices. This price inflation was an economic boon to oil-patch states.<sup>3</sup> During the five-year period ending in second quarter 2008, inflation-adjusted economic growth in these four states grew at an annualized rate of 3.6 percent

<sup>1</sup> FDIC, *History of the Eighties—Lessons for the Future* (Washington, DC: FDIC, 1997): 291–336.

<sup>2</sup> *Ibid.*, 259–290.

<sup>3</sup> While the energy discussion and analysis in this article focus on oil-patch states, it should be noted that Wyoming and Montana have characteristics similar to this region. Both states rely considerably on energy extraction and experienced employment growth above the national average during the period of high oil prices. Wyoming, in fact, had one of the most vibrant economies in the nation during that time.

Chart 1



compared with 2.8 percent for the nation.<sup>4</sup> The biggest impact, however, was on real personal income, which grew at an annualized rate of 4.6 percent in the four oil-patch states compared with only 2.9 percent nationally. The region's oil and gas industry not only supports a large number of high-paying jobs in the mining industry itself, but also has strong, indirect multiplier effects on job growth in professional and business services, wholesale and retail trade, and financial activities.

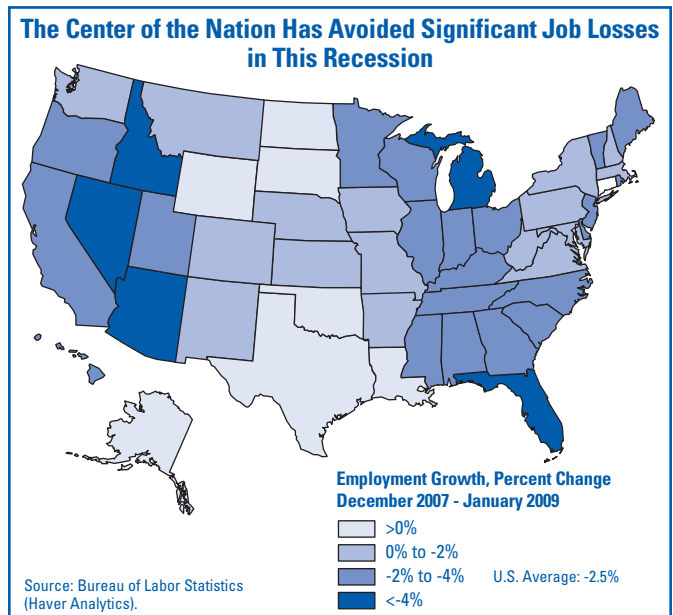
The agricultural sector also has performed quite well over the past few years. A number of factors, including global economic growth and a weaker dollar, contributed to an extended period of rising prices for a broad array of agricultural products. Prices for these commodities generally began to rise in late 2002, and many reached new highs in the past two years before moderating in the second half of 2008 (see Chart 1). High commodity prices have led to record net farm incomes in three of the past four years and also have contributed to significant increases in farmland values.<sup>5</sup>

Ethanol production has also played an important role in both agricultural and energy markets in recent years. As the price of crude oil increased from less than \$26 per barrel in 2001 to more than \$133 per barrel in July 2008, ethanol became a viable and very profitable alter-

<sup>4</sup> Growth rates used in this paragraph were calculated by the FDIC using data from the U.S. Bureau of Economic Analysis and Moody's Economy.com.

<sup>5</sup> For a detailed farmland analysis, see Richard D. Cofer, Jeffrey W. Walsler, and Troy D. Osborne, "Do Record Farmland Prices Portend Another Steep Downturn for Agriculture and Farm Banks?" *FDIC Quarterly* 2, no. 4 (2008): 25.

Map 1



native. Strong profitability, government mandates on renewable fuels that supported demand, and tariffs and subsidies that supported prices all led to considerable increases in ethanol output.<sup>6</sup> Indeed, annual ethanol output in 2008 had grown by more than five times the levels of 2000.<sup>7</sup> The growth in ethanol production, in turn, increased the demand for corn, the primary input in the production process, to a point where ethanol production is projected to use nearly 30 percent of the 2008 crop.<sup>8</sup> As farmers planted more corn to meet the higher demand from ethanol plants, they reduced plantings of soybeans, which contributed to higher prices for this commodity as well. The result was record incomes for farmers and double-digit average annual increases in farmland values in corn- and soybean-producing states between 2003 and 2007.

The health of the energy and agricultural sectors, combined with relatively stable and affordable housing markets in the central United States, has caused the national recession to largely bypass the nation's midsection so far (see Map 1). The energy-rich oil patch was

<sup>6</sup> Don Hofstrand, "Corn-Ethanol Profitability," *AgMRC Renewable Energy Newsletter*, Agricultural Marketing Resource Center, November/December 2008; and Bruce A. Babcock, Center for Agricultural and Rural Development at Iowa State University, statement before the U.S. Senate Committee on Homeland Security and Government Affairs, Hearing on Fuel Subsidies and Impact on Food Prices, 110th Cong., 2nd sess., May 7, 2008.

<sup>7</sup> Renewable Fuels Association, *Ethanol Industry Outlook 2009*.

<sup>8</sup> "World Agricultural Supply and Demand Estimates," U.S. Department of Agriculture, January 12, 2009.

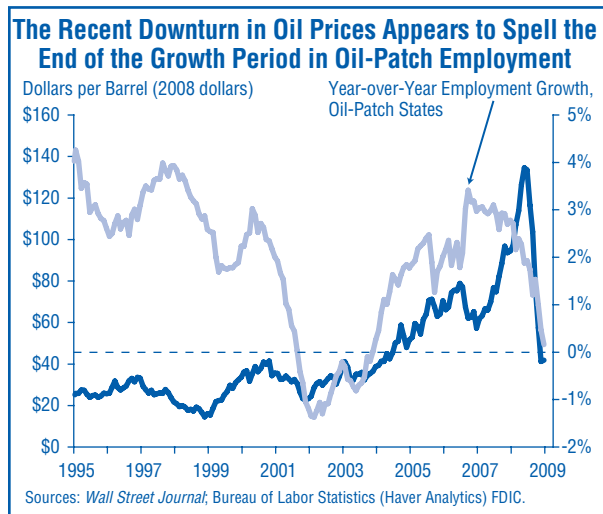
the only region that added jobs after the national recession began in December 2007, and Farm Belt states reported small job losses relative to the rest of the nation.

### The Outlook for Energy and Agriculture Has Dimmed

Though the energy and agricultural sectors have provided insulation against recession for the central United States, these sectors have weakened considerably in recent months. The *Energy Information Administration's* (EIA) short-term energy outlook is projecting a long, severe global economic slowdown that will lead to further reductions in global energy demand and additional declines in crude oil and other energy prices.<sup>9</sup> The EIA projects oil prices in 2009 to average between \$40 and \$50 per barrel on a quarterly basis, but prices could plunge below \$30.<sup>10</sup> Falling energy prices are now putting pressure on oil-patch employment growth (see Chart 2). This trend alone should not cause a repeat of the 1980s oil bust, as the region's economy has become increasingly diverse since that time, somewhat muting the impact of oil price movements.<sup>11</sup> However, when falling energy prices are combined with a severe national recession and a global financial crisis, a significant regional downturn cannot be ruled out.

Declining agricultural commodity prices are also of concern. A severe downward price cycle in agricultural commodities and land values that causes farm incomes and land values to fall could result in prolonged economic weakness among farm states. Aggravating the situation could be a rapid and significant consolidation in the ethanol industry, which was already showing weakness in mid-2008 because of overcapacity and low margins caused by high corn prices. Some of the largest ethanol producers delayed the startup of ethanol plants last year, and some analysts predicted that many small and medium-sized plants would shut down.<sup>12</sup> Deteriorating conditions in the ethanol industry will not only

Chart 2



weigh on crop prices, but are also likely to affect farmers and rural communities who have come to rely on the industry for high-paying jobs.

Though the economies in the nation's midsection continue to perform well relative to the nation, the downward trends in the energy and agricultural sectors may weigh on the region in the near future. Moderating commodity prices are likely to put a damper on the area's economic conditions, and the region may not only cease to be a source of economic strength but also could enter recession at a much later stage than the nation.

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<sup>9</sup> Energy Information Administration, *Short-Term Energy Outlook*, December 2008.

<sup>10</sup> Several leading analysts have discussed the possibility of oil prices falling below \$30 per barrel in 2009. One notable example is "Oil May Fall Below \$25 Next Year, Merrill Lynch Says," Bloomberg.com, December 4, 2008.

<sup>11</sup> Stephen P.A. Brown and Mine K. Yucel, "Energy Prices and State Economic Performance," Federal Reserve Bank of Dallas, *Economic Review*, second quarter 1995.

<sup>12</sup> "Too Much Ethanol?" *Farm Industry News*, November 1, 2008.