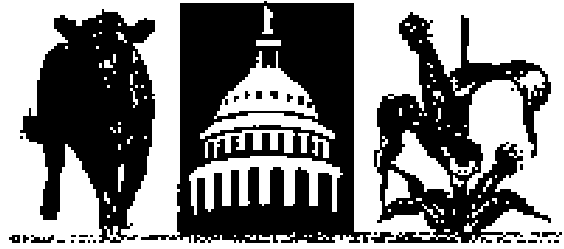


# ECONOMIC AND POLICY UPDATE

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### **Farm Bill and Energy Policy Update: Implications for U.S. Agriculture**

Debate over the farm bill continues this month as the 110<sup>th</sup> Congress returns from the holiday break. The House of Representatives returned to session on January 15th, while the Senate will reconvene on January 22<sup>nd</sup>. The House passed its version of the new farm bill in late July 2007 (H.R. 2419), while the Senate's farm bill was completed on December 14<sup>th</sup>.

An extension was passed late last year as a part of a large appropriation bill to extend some of the dairy, conservation and other provisions of the 2002 farm bill that needed immediate attention. This extension had no effect on other traditional farm bill crops for 2008 and beyond.

A conference committee, whose members have yet to be named, will be assigned the task of resolving the differences in the two bills. Senator Tom Harkin (D-IA) will serve as the chairman. While everything appears to be on the table at this point, payment limitations, funding mechanisms, the average crop revenue program, and WTO concerns will likely receive a lot of attention in the conference committee. Once all differences are

resolved, the legislation goes back to both chambers for final approval before heading to the President. At this time, President Bush is still indicating he will veto the farm bill unless some of the issues outlined above are addressed.

While farmers are paying close attention to the farm bill debate, many policy analysts are claiming that the single biggest policy event affecting the future of the farm economy is the new energy bill. The *Energy Independence and Security Act of 2007* was signed into law on December 18, 2007. This legislation increases the fuel efficiency standard from its current level of 25 mpg to 35 mpg by 2020. It also calls for renewable fuels to increase from the current annual level of around 7 billion gallons to 36 billion gallons by 2022, with 15 billion gallons coming from corn-based ethanol and the remaining 21 billion gallons from cellulosic-based biofuels. Industry officials estimate that ethanol capacity will total around 13.5 billion by the end of 2008, but various constraints (e.g., transportation, distribution issues, corn supply) will prevent the industry from running anywhere near full capacity in 2008. About 25% of the corn crop this past year was used for ethanol production. Future utilization of corn for energy hinges on the profitability of corn-based ethanol production, which is linked to the price of oil relative to the price of corn. A recent study indicates that \$100/barrel oil price translates into a breakeven price for corn for ethanol production of nearly \$7.40/bushel, but if oil falls to \$60/barrel, the breakeven corn price is around \$4.00/bushel.

Another important issue in this debate is how quickly cellulosic ethanol technology will evolve? Will it be economical to produce, store, and transport? There also continues to be a lot of debate

about the short and long-term effects of a changing energy policy toward renewable fuels and how that will impact the livestock sector and food prices.

Obviously these are interesting times for U.S. agriculture, following a year of record cash receipts, net farm income, exports, and soaring real estate values. While commodity prices entering 2008 are near or above historic levels, production expenses (fertilizer, fuel, feed, wage rates) are also escalating. Along with greater opportunities and higher prices comes greater risks and heightened volatility at a higher plateau level. Consequently, farm business managers need to develop sound management and marketing plans to adjust to this rapidly changing and volatile marketplace. (Will Snell)

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## **A Global Look at Biofuels**

Biofuels, especially ethanol and soy diesel, have been in the news for the past several years in the U.S. as energy policy changed in Washington D.C. and as the cost of oil and consequently gasoline has risen. But interest in biofuels is not confined to the United States. Indeed it's of strong interest worldwide, but especially in the European Union countries and in Brazil. Biofuel production globally has tripled in the past seven years, but it still accounts for less than 3% of global transportation fuel supply. Oil in the form of gasoline and diesel fuel still dominates. Approximately 90% of world biofuel production is concentrated in Brazil, U.S. and the European Union.

Increased demand for ethanol and soy diesel has helped fuel higher world food and feed prices. The International Monetary Fund (an international organization) estimates that world food prices rose 10% in 2006 (food prices in the U.S. only rose 2.4%) because of increases in corn, wheat and soybean prices that were being driven, in part, by increased demand for biofuels. As a consequence countries have responded differently. The Chinese put a moratorium on expanded use of ethanol because of rising feed prices. The Mexican government capped tortilla prices in 2007 to contain food price inflation from higher corn prices. Obviously, U.S. livestock producers are dealing with the increased feed costs.

Several factors are driving the increased demand for biofuels globally. First, higher oil prices have increased the attraction of biofuels as a partial substitute for imported oil. Previous periods of oil price increases were relatively brief, but clearly there has been a structural change in global oil supply and demand suggesting higher oil prices for the foreseeable future. However, these higher oil prices are causing energy companies in the U.S. to seek additional recoverable oil supplies from areas as varied as North Dakota to Texas. Deeper offshore drilling sites are also being investigated.

The cost of feedstock is the most expensive component in biofuel production. Corn, in the case of U.S. ethanol production, accounts for approximately 50% of the cost of production. Sugarcane is the feedstock in Brazil but it represents about 35% of the cost of production. In the European Union the feedstock is typically sugar beets which also represents about 35% of production costs.

Governments also play a role in biofuel production. The U.S. provides a 51 cent per gallon refund for blenders of ethanol and \$1 for biodiesel from vegetable oils and animal fat. Some states provide additional incentives. Europe offers 18.7 Euros per acre energy premium for production of biofuel feedstocks. Brazil does not directly subsidize production of ethanol, but they do encourage ethanol consumption by charging a lower sales tax on ethanol than on gasoline..

What about the future? It's mostly a list of unknown questions including: How high will oil prices go? How fast can cellulosic ethanol become cost competitive? What about the environmental impact of producing more feedstocks (such as corn, wheat and soybeans) from marginal land? What about using land for fuel versus feed and the impact on livestock producers and food prices? What other liquid biofuels may come on line in the future such as coal gasification? What role will government policy play? What role will conservation efforts play? Ultimately, these questions will likely be answered by profitability and the development of new technologies. But it is clear that biofuels in some capacity will continue to be a part of the global response to higher oil prices over time. (Larry D. Jones)

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## Re-thinking Local Economic Development for Kentucky

During the last several months I have had the opportunity to meet with judge executives from approximately fifteen Eastern Kentucky counties. With the exception of a few, when asked about their current economic development programs, the judges stated that they were organizing efforts to recruit a large technology-based firm. They talked about the various incentives the county and state were willing to offer. However, if a particular company is considering neighboring counties as a potential location, the only unique incentive would be that offered by the county. It is true that the rural areas in Kentucky might be enticing to large firms because of the lower cost of living, less expensive labor, and scenic amenities, but large manufacturing firms aren't necessarily looking for the cheaper way out anymore. These highly technological firms, such as Toyota, are looking for a skilled, albeit, higher-wage labor force and in turn are often ignoring small, rural areas in location decisions.

There have been two new waves of local economic development strategies that have been pursued in the last decade that might be more promising for small communities. The first is to focus on retaining and expanding the current businesses in the community. It is important to provide local businesses with the same incentives and promises offered to new enterprises. Survey these businesses to determine their needs and concerns and find out what the county can do for them to ensure they remain in the area. The question to ponder is: "Is it more devastating to fail in recruiting a business or to lose a business already employing local residents and providing wealth for the community?"

The second new wave in local economic development strategies reduces the emphasis on incentives and firm-based assistance and focuses on a more regional approach to economic development. The goal of this approach is to build institutional and individual capacity while recognizing the need to recruit industry and promote entrepreneurship. These programs reflect community and business collaborations that are

designed to build entire industrial sectors that are globally competitive. Thus, a community does not ride on the success or failure of a single firm.

This last wave of thinking is especially relevant to the communities in Eastern Kentucky who understand that the natural resources in the area could potentially allow the entire region to specialize in eco-tourism. Each community has a unique idea about how to plan and implement eco-tourism strategies, however they are acting in isolation without considering the needs and wants of the residents, schools, churches, and neighboring communities. Thus, this approach is similar to developing a program with a single firm in mind as opposed to building an entire institution where each community involved benefits from this network. By itself, tourism will not replace jobs in rural economies. Revitalizing an area to a quaint small town is appealing but much more is required to strengthen the economic viability and job potential.

No one economic development strategy is 100% effective. It takes the involvement of everyone in the community to determine the best approach to take. With areas so rich in culture and family, Kentucky's smaller communities are ripe for considering this new all-inclusive strategy towards economic development. By abandoning the practice of recruiting firms as the sole strategy, communities can focus on the needs of small businesses already operating in the area as well as the local residents. (Alison Davis)

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## Hog Market Update

The USDA released the December Hogs and Pigs inventory report in late December. This report indicated that the number of all swine was up 4% from last year, but down slightly from two years ago. The biggest increase was in the category of hogs over 180 pounds, with numbers up more than 6%. Of course, a large portion of those animals have already been sent to slaughter since the report is for December 1. Slaughter figures for December, up 9%, are consistent with that view.

Iowa is by far the largest hog producing state, and its inventory was up 5%. North Carolina, second in production, had a 4% rise. Of states in the top ten,

only Illinois had a decline (1%). Kentucky is ranked 17<sup>th</sup> in live hog production. Our numbers were up 13% – with no change in the sow herd, but a 15% increase in the market hog category showing that most of our increase is due to the contract hog finishing.

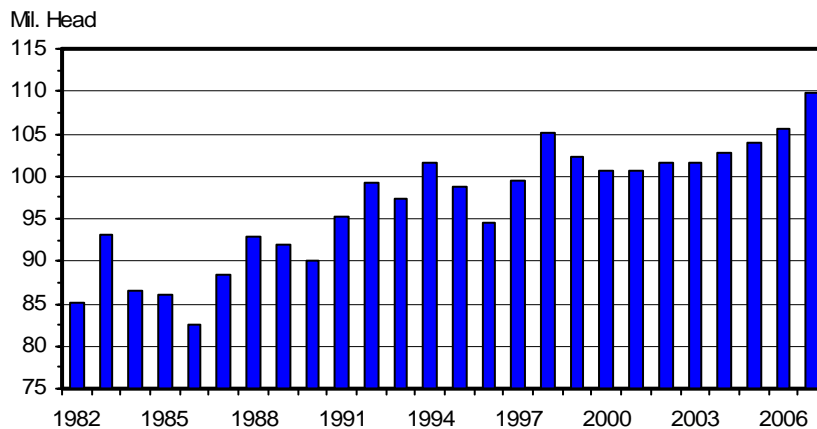
For 2008, production is likely to increase. Not only will the existing inventory be sent to harvest, but more pigs are expected to be born. Farrowing intentions for the first quarter of 2008 are up 2% from last year and 5 percent over 2006. Intended farrowings for the March to May quarter are just a bit over last year's level. As grain prices continue to rise, producers may scale back production, but overall production for 2008 is still likely to rise about 2% to 3%.

According to Ron Plain at the U. of Missouri, history suggests that production declines 15-16 months after producers start losing money, which began in October, 2007. That suggests declines in production, but not until early 2009.

The increase in production suggested by the USDA report, combined with record large total meat production will put downward pressure on prices. A positive side though, is continued strength in U.S. pork exports, which continue to get cheaper for the buyers in other countries as the exchange rate of the dollar weakens. The bottom line is that prices are likely to decline by \$3 to \$5 per cwt. from the 2007 level. While that is not a major drop, the increase in feed costs will add to the negative profit impact. (Lee Meyer)

### ANNUAL U.S. PIG CROP

USDA Hogs and Pigs Report, 12/27/07



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