FEDERAL RESERVE BANK OF MINNEAPOLIS

JANUARY 2010
VOL. 22 NO. 1

fedgazette

Regional Business & Economics Newspaper

minneapolisfed.org

THE CRACKED GLASS SLIPPER? page 6

Bank fallout from CRE difficult to gauge.

A CALL TO ARMS page 8

Gun sales surged during the recession.

DISTRICT ECONOMIC OUTLOOK page 10

District and nation emerge from recession.

DISTRICT TRADE PATTERNS SHIFTING page 13

Trade growth has followed economic growth.

ANOTHER SLOW YEAR? page 14

Business leaders predict sluggish growth.

MANUFACTURING SLUMPED IN 2009 page 15

But firms expect small bounce this year.

Collateral damage

While real estate still struggles through the housing collapse, commercial mortgages are piling on more pain

By RONALD A. WIRTZ
Editor

If you're a professional in the commercial real estate industry, it's probably akin to being locked in a car, with no steering wheel or brakes, heading into a potentially violent, slow-motion crash.

Commercial real estate (CRE) is that part of the economy involved in imagining, financing, building and managing the offices, production plants, storefronts and other businesses that drive much of the economy.

CRE has been making a lot of news lately, and for all the wrong reasons. Much like its residential sibling, it experienced a boom through the middle part of this decade and is now facing the ramifications of that excess. Vacancy rates across the district are rising—often steeply—in office, retail and other CRE submarkets. That's pushing down rents and putting new CRE projects in a deep freeze, among other problems.

As a senior vice president for CB Richard Ellis, an international real estate services firm with offices in the Twin Cities, Murray Kornberg has watched both the huge run-up in the CRE market during the past decade and, in his words, the "nuclear winter" currently gripping the sector. "We were going fine and then fell off a cliff."

The industry faces the prospect of widespread defaults, thanks to a triple whammy of slack demand, plummeting prices and tight credit—a rolling real estate snowball that offers challenges not only to property owners, but investors that financed the boom in the first place. As a result, a badly suffering CRE industry is on the minds of investors, in the speeches of regulators and virtually the only topic of conversation at industry mixers.

CRE borrowers face two different, but related, challenges. Most obviously, the recession is making life difficult for

Continued on page 2

The *fedgazette* is moving to a quarterly schedule (January, April, July and October) to bring more focus and resources to the *fedgazette* online. Look to **www.minneapolisfed.org** for enhanced coverage and analysis, including new types of information and ways to stay informed about the Ninth District economy.

CRE from page 1

many businesses. As businesses close, vacancy rates for office, industrial and retail properties are rising, and building owners are having trouble keeping enough cash flow to meet their mortgage payments.

The other challenge is a quirk of boom financing during the CRE heyday, when real estate prices and transactions rose steeply. Investors competing to finance the CRE boom locked in loans at fast-rising values with relatively short—and now, ill-timed—maturities. A throng of CRE loans now face maturity with no clear resolution. Property values have plummeted, putting many CRE loans at a loan-to-value ratio that's too high to refinance. And investors, including lenders, have tightened credit across the board (see page 6 for more discussion of banks and their CRE loans).

Investors and borrowers alike are searching for escape hatches. While certain options, like loan extensions and other modifications, might be appealing and ultimately helpful given the circumstances, none is without risk; at best, they might lessen collateral damage as investors and borrowers nervously await recovery in CRE markets and the economy more generally.

How did we get to this place?

First, a few formalities. There is no tight definition of "commercial real estate" among the various sectors involved in this market. In general, the term is meant to refer to buildings and other property used by owners to generate profit from either space rental or property appreciation. For this article, "commercial real estate" refers to (but is not necessarily limited to) buildings and other property used for industrial, office, retail, medical or educational purposes, as well as residential properties having more than four dwelling units. That definition changes slightly for what banks and their regulators define as CRE lending. (See more discussion on page 6.)

Now, back to the journey taken by the commercial real estate sector this decade. Its current position is not particularly difficult to trace. The industry witnessed significant new development, as well as heavy buying and selling of existing properties, through about 2007. Both trends boosted overall demand for CRE and sent related property values skyward.

In the seven-county Twin Cities region—far and away the largest market in the Ninth District—both the value and number of building permits for new office, retail, industrial and other CRE projects saw robust activity through 2006, and even 2007 wasn't a terrible year in terms of permit value (see Charts 1 and 2).

On top of new development, CRE properties saw a dramatic increase in the number and value of transactions, as property owners used favorable lending conditions to refinance properties and investors used an appreciating market to make money buying and selling properties. During this period, retail and office saw particularly heavy action in the district. In Minnesota, for example, the value of retail CRE transactions rose from $200 million in 2001 (inflation-adjusted) to more than $3 billion by 2006, according to data from Real Capital Analytics, a real estate research firm that tracks transactions and other activity; office sales went from $250 million to over $2 billion.

All of this CRE activity—lots of new development and high demand for existing properties—had the effect of driving up CRE values. In Hennepin County, home to Minneapolis and its suburbs, the estimated property value of commercial and industrial land increased almost 50 percent between 2003 and 2008—to almost $30 billion, according to figures from the county's most recent comprehensive annual financial report. That's an even faster pace of appreciation than housing experienced during the same period.

But in a cliché that was surely thought up by the real estate industry, what goes up eventually comes down, oftentimes hard. Starting in 2007, CRE started to soften and then turned downright squishy by 2008. CRE transactions nationwide plunged off the cliff, while district transactions merely fell down a steep hill (see Charts 3 and 4).

New CRE development also slowed dramatically. In the Twin Cities region, total CRE permits fell by more than half (53 percent) from 2006 to 2008, and a variety of sources show that 2009 has been worse. In Minneapolis, for example, there were 15 commercial building permits in the first half of 2009 exceeding $1 million in value, compared with 42 in the first half of 2006, according to city figures.

Most of the district played follow-the-leader. The city of La Crosse, Wis., approved 23 commercial and industrial permits in 2007, according to city officials. In the subsequent 22 months (through early November 2009), the city approved just 20 projects. In Marquette County, home to the largest city in the Upper Peninsula of Michigan (Marquette), permit activity hit 31 in 2007, according to Eric Anderson, a county senior planner. Through October of 2009, just 15 permits had been issued. More notable was the drop in permit value, which dried up from $47 million to just $4 million.

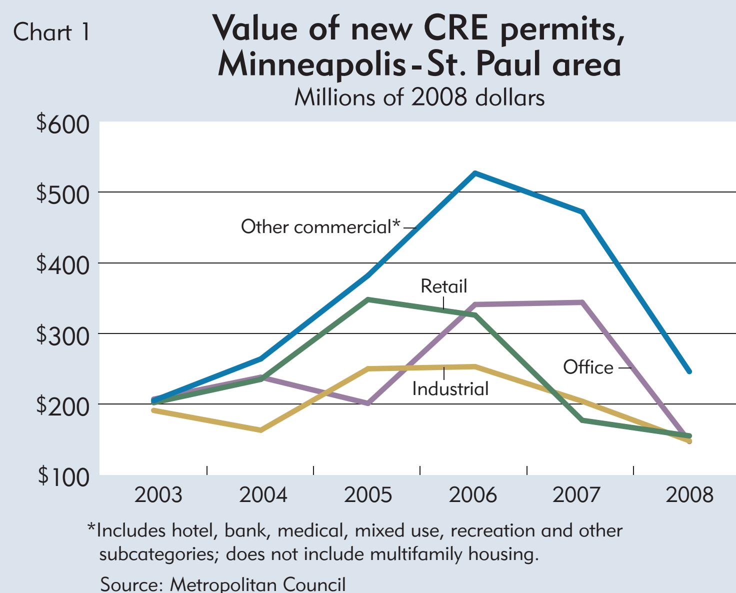
The CRE market in Billings, Mont., has lagged the rest of the district, in part because the entire state felt the effects of the national recession later than the rest of the country. Billings saw continued growth through 2008, but activity was cut roughly in half in 2009, according to Mary Bradley, the city's permit coordinator. Commercial permits through October of 2009 fell to 40, compared with 75 for the same period a year earlier. Permit value dropped from $85 million to $45 million.

CRE Roller Coaster

Chart 1

Value of new CRE permits, Minneapolis-St. Paul area

Millions of 2008 dollars

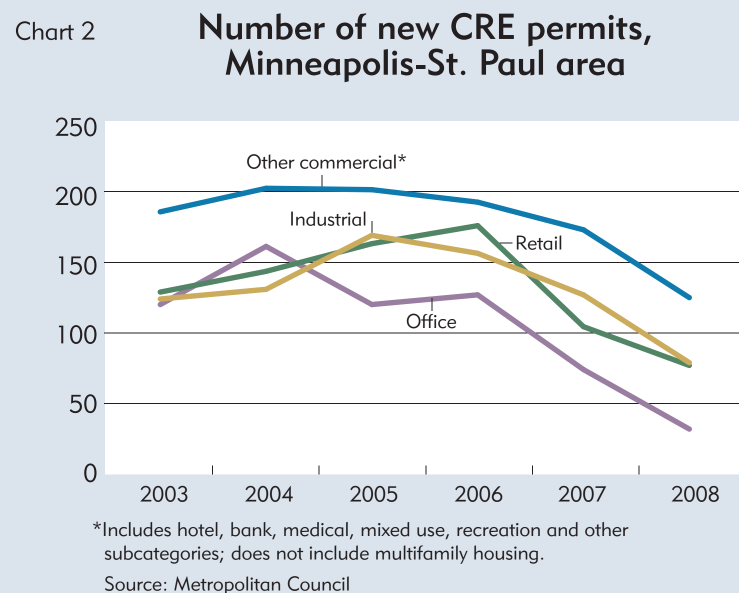


*Includes hotel, bank, medical, mixed use, recreation and other subcategories; does not include multifamily housing.

Source: Metropolitan Council

Chart 2

Number of new CRE permits, Minneapolis-St. Paul area



*Includes hotel, bank, medical, mixed use, recreation and other subcategories; does not include multifamily housing.

Source: Metropolitan Council

fedgazette

FEDERAL RESERVE BANK OF MINNEAPOLIS
Regional Business & Economics Newspaper

ISSN 1045-3334

Subscriptions are available without charge. Back issues are available on the Web. Articles may be reprinted if the source is credited and Public Affairs is provided with copies. Permission to photocopy is unrestricted. Send correspondence to Public Affairs, Federal Reserve Bank of Minneapolis, 90 Hennepin Avenue, P.O. Box 291, Minneapolis, MN, 55480-0291; (612) 204-5255.

E-mail: letters@mpls.frb.org
Internet: minneapolisfed.org

One of the Minneapolis Fed's congressionally mandated responsibilities is to gather information on the Ninth District economy. The *fedgazette* is published quarterly to share that information with the district, which includes Montana, North and South Dakota, Minnesota, northwestern Wisconsin and the Upper Peninsula of Michigan.

The opinions expressed in the *fedgazette* are expressly those of the authors or of attributed sources and are not intended to represent a formal position of this bank or the Federal Reserve System.

EXECUTIVE EDITOR Arthur J. Rolnick
SENIOR EDITOR David Fettig
EDITOR Ronald A. Wirtz
MANAGING EDITOR Jenni C. Schoppers
SENIOR ECONOMIST Terry J. Fitzgerald
REGIONAL ECONOMIST Tobias Madden
ASSOCIATE ECONOMIST Rob Grunewald
SENIOR WRITERS Douglas Clement, Phil Davies
STAFF WRITER Joe Mahon
ART DIRECTOR Phil Swenson
GRAPHIC DESIGNERS Rick Cucci, Mark Shafer

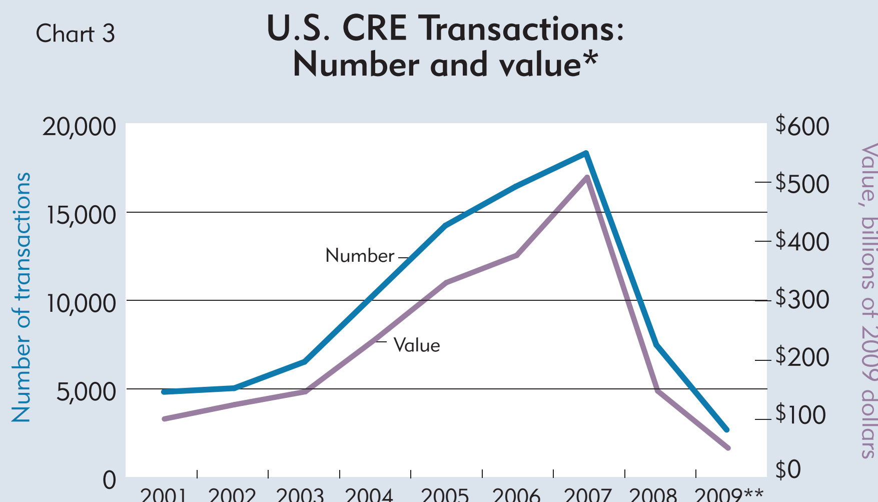
Continued on page 4

Commercial real estate borrowers face two different, but related, challenges. Most obviously, the recession is making life difficult for many businesses. As businesses close, vacancy rates for office, industrial and retail properties are rising, and building owners are having trouble keeping enough cash flow to meet their mortgage payments.

U.S. and District CRE Transactions Fall

Chart 3

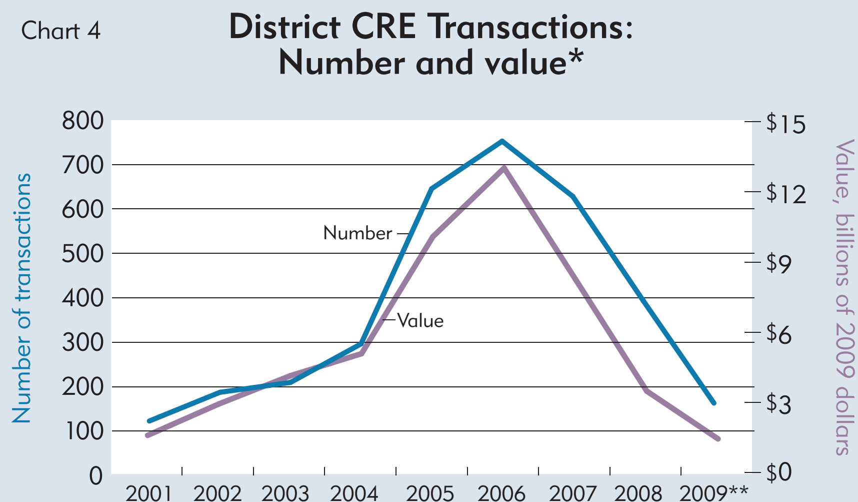
U.S. CRE Transactions: Number and value*



* Transactions over $5 million
**Annual projection based on activity through first 9 months
Source: Real Capital Analytics

Chart 4

District CRE Transactions: Number and value*



* Transactions over $2.5 million
**Annual projection based on activity through first 9 months
Source: Real Capital Analytics

On Line

- We are asking for your feedback regarding your readership of the *fedgazette*. Go to the *fedgazette* January issue online and look for the Feedback Survey.
- Give us your perspective on the types of articles and information you are looking for from the *fedgazette* on the Ninth District economy.
- Let us know how you like to stay informed about updates from the Minneapolis Fed and for the *fedgazette*.
- Offer your comments on future items of interests and ways that you think we could improve your access and experience reading the *fedgazette*.

CRE from page 2

Real estate booms and busts are hardly novel. What is new today is the potential depth of the problem, caused by the fact that many CRE borrowers face two solvency challenges: The first and most obvious one for a commercial property owner is not being able to pay the mortgage, which happens if tenants are struggling and behind on their rent or go out of business altogether and the space becomes vacant and earns no revenue.

And that's happening. Vacancy rates are rising across the district and in most submarkets like retail, office and industrial. Colliers Turley Martin Tucker, a national CRE firm with an office in Minneapolis, said in a report on third-quarter conditions that office and industrial vacancies in the Twin Cities hit 19.6 percent and 12 percent, respectively—both up a couple of percentage points since the end of 2008.

Office vacancy in the Sioux Falls region hit 16 percent in 2009—the first time in history the city's vacancy rate exceeded the national rate, according to Douglas Brockhouse, a principal with Bender Commercial Real Estate Services, via e-mail. He added that the firm isn't involved with financing, but he knew of a number of developers that reportedly have "handed the keys to properties to the banks and told them to figure it out."

Compounding the problem is that property owners have had to start discounting rent to attract new lessees, which also gives an incentive to existing tenants to ask for lease concessions or go looking for new space. Rental rates on the best office space in Sioux Falls have dropped from $15 to $11 a square foot, according to Brockhouse. Industrial vacancy remains under 5 percent, yet rents dropped about 20 percent over last year.

Jim Villa, president and CEO of the Commercial Association of Realtors Wisconsin (CARW) said that the state's office market is seeing vacancies rise and rents fall, "and property owners are struggling to hold clients." It's affecting new development as well, as many firms are considering contracting existing space because of their leverage in a soft market, rather than expanding facilities or building anew.

Maturity default

The second challenge facing CRE owners might seem more mundane, but is potentially more ominous. It involves the maturing of existing CRE loans.

To understand the predicament, first go back to the boom years. Strong demand meant that many new developments and existing properties were getting financed or purchased at rapidly rising prices and on terms much shorter than residential mortgages—typically five to 10 years and even shorter for booming construction and land development loans.

Now fast-forward to the present. A wave of CRE loans from the gravy years are maturing, or coming due. Unlike most home mortgages, where the buyer makes monthly payments until a loan is paid off, a commercial real estate loan typically involves monthly payments followed, at the maturity date, by a large equity balloon payment for the balance of the loan. Often these loans simply get refinanced or are paid off through a new loan from a different bank or through the sale of the property to an interested investor.

But these loans only get refinanced (or picked up by other lenders or paid off through a property sale) if the collateral property retains its appreciated value. And that's not happening. In a replay of the housing collapse, CRE values have crashed since 2007. How much is difficult to say, because each market is unique and there are few concrete data on such matters, especially at the local level. Nationwide, prices have reportedly declined between 25 percent and 40 percent since their peak in the fall of 2007, according to various sources, and market conditions suggest that they will fall further. In the district, declines are expected to vary widely, depending on the health of the local market and the degree of price appreciation during the boom.

Falling property values means that many maturing CRE loans are underwater—borrowers owe more in loan principal than the collateral property is worth—and few property owners have cash on hand to meet the balloon payment; if they did, few would likely leverage it in a market that many believe has not yet hit bottom. Even on loans that retain some equity, loan-to-value ratios are typically too high for either the current lender or a prospective new one to extend credit.

In other words, it's a classic boom trap. The magnitude of the maturity risk is difficult to peg. US Bank estimated in 2009 that CRE loans worth $271 billion were maturing in the United States, a rising tide that is expected to reach $600 billion by 2017. Daniel Tarullo, a governor on the Federal Reserve Board, has estimated that almost $500 billion in CRE loans will mature each year over the next few years. Of course, not every maturing loan will be in an equity pickle. But according to Foresight Analytics, a California-based real estate consulting firm, about $770 billion in commercial mortgages set to mature in the next five years are currently underwater.

In a soft market, property owners have been forced to renegotiate leases to maintain sufficient cash flow and make monthly payments. But the resulting drop in property income means that loan-to-value ratios have gone out the window."

A fuzzy elephant

The district picture is more difficult to discern. According to a Federal Reserve Board analysis (using data from Real Capital Analytics), the number of CRE properties in distress as of October was lower in the Ninth District than in any other Federal Reserve district, and the total value of those distressed properties was the second lowest of the 12 Reserve districts. But the RCA database tracks only higher-value properties and transactions, of which there are comparatively few in the largely rural Ninth District.

But there is widespread evidence of CRE problems in the district. Jill Rasmussen is a principal at the Davis Group, a small CRE firm in Minneapolis, and has 25 years of experience in the office and health care sector. She said she knew of "several large properties" that were purchased in the Twin Cities at high values and now have maturing loans. "The values of these properties have declined, and refinancing will be very challenging or impossible," Rasmussen said.

Brockhouse, from Bender Commercial, said there were too many underfunded investors in a growing Sioux Falls market that developed properties "that were not preleased or were leased to companies that never had a chance of fulfilling their lease obligations."

In a soft market, property owners have been forced to renegotiate leases to maintain sufficient cash flow and make monthly payments. But the resulting drop in property income means that loan-to-value ratios "have gone out the window," Brockhouse said. "When it comes time to renegotiate a new loan, every one of them is going to have to write a significant check to bolster the equity that they have in the property. The problem is that the landlord-investors don't have the capital to write those checks."

That problem is exacerbated by the fact that credit has tightened from all financing sources, including banks. According to nationwide quarterly surveys of senior loan officers by the Federal Reserve, CRE loan standards were tightened by about 80 percent of responding banks in all four quarters of 2008 and the first quarter of 2009. By the second quarter of 2009, those figures started to come down and stood at 35 percent in the third quarter (October) survey. That's better, but banks indicated that current lending standards were still much tighter than average levels over the long term.

District sources widely reported that borrowers—even new buyers looking to scoop up good deals—were facing much higher equity demands to get a CRE loan; during the boom, a borrower could expect to borrow up to 90 percent of a property's collateral value. Today, lending limits are being set at about 65 percent of an already depreciated asset. "One thing buyers need is cash, and lots of it," said the Colliers report on third-quarter conditions. "With the continued tight credit markets, banks require more money down to make a deal happen. Unfortunately, very few companies have the luxury of holding extra cash."

Kornberg, from CB Richard Ellis, sees a "big maturity risk" in the market

because of the scarcity of credit. Many loans are healthy and performing well, but at maturity "they don't have the equity to get the [refinancing] job done," he said. "I don't believe banks are walking away from good deals. But if you're going to make a loan in this environment, the deal better be very good."

That mentality shows up in the data. According to a third-quarter 2009 survey by the Mortgage Bankers Association, commercial and multifamily mortgage loan originations in the third quarter were 12 percent lower than in the previous quarter and 54 percent lower than in the same period in 2008.

Villa, from CARW, said Wisconsin has "a growing problem of properties facing loan maturity and not being able to find a lending institution to rewrite the loan. … For the most part, brokers and owners are saying it has become extremely difficult to find refinancing."

CRE borrowers also have fewer financing options than during the boom. For example, through 2007, ample credit was available through commercial mortgage-backed securities—CMBS, the same mortgage-finance tool that created the subprime mortgage frenzy and played a lead role in the housing collapse. During the boom, CMBS financed about one-quarter of CRE deals, peaking at $250 billion in 2007, and then crashed back to "not one dime this year," Kornberg said. "That's a supernova."

Though CMBS financing is believed to have been used much less often in the district, and district banks hold comparatively little CMBS debt on their books, capital is nonetheless finite and mobile, and the implosion of CMBS shrank available capital and increased competition nationwide for what remained.

In short, CRE financing has morphed from easy money at inflated prices to hard money at depreciated values.

Fork in the loan road

The path out of the CRE woods is not particularly clear. Already, CRE loan delinquencies are increasing (see page 7), and the number of properties facing loan maturity is reportedly climbing in step with the previous rise in total financings during the boom. Given the circumstances, borrowers facing either term or maturity default are hoping for patience from banks and other sources of CRE financing.

From a lender's standpoint, both term and maturity defaults offer a choice between two unsavory options. Foreclosure is the most obvious option, and a good one to ensure that lenders recover some of their investment.

Another option involves refinancing or modifying a loan with new terms (including a maturity extension) in hopes that an economic rebound will allow borrowers and properties the ability to make their way to the proper side of the ledger. Such a strategy can offer safe harbor for those needing some time to rebound with a recovering economy, as well as for those already performing well but facing an equity gap.

Without necessarily approving of these so-called loan workouts, bank regulators, including the Federal Reserve, issued guidelines this past fall that encourage lenders and borrowers to modify loans where appropriate and prudent. The IRS also issued changes regarding its view of bank loan modifications. Taken together, some believe these regulatory moves offer much-needed flexibility for borrowers and lenders alike while the economy and the CRE market stabilize and allow the CRE conflagration to become more a controlled grass fire than a scorched-earth forest fire.

Villa, from CARW, said, "I don't think a significant percentage of properties will end up in default." Many might approach default, he said, which would give both borrower and lender the incentive to be creative. "Will you see a double-digit increase in the percentage of properties going into default in 2010? I think it's possible, but more likely I think people are going to be working with lenders to bridge the gap creatively [by finding mutually beneficial ways to modify or extend loans] between now and when the credit markets loosen up again."

The biggest problem for property owners and their debt holders is a CRE market that's predicted to get worse before it gets better. Heavy job losses, high vacancy rates and tight credit have created the rolling CRE snowball.

Between a rock and a soft loan

Nonetheless, the biggest problem for property owners and their debt holders is a CRE market that's predicted to get worse before it gets better. Heavy job losses, high vacancy rates and tight credit have created the rolling CRE snowball. Regardless of loan workouts, the amount of distressed property is expected to increase, keeping supply high and reinforcing the lid on any value appreciation.

As such, while the regulatory flexibility might help, the real key will be the timing and, pace of recovery in the CRE market. Unfortunately, most sources aren't particularly optimistic on that front. A mid-year report on the Twin Cities market last summer by Northmarq, a regional CRE firm, said, "It's clear that the market will see an increase in distressed ownership situations during the second half of 2009 and into 2010 as more landlords face cash flow problems" while dealing with pressure from their lenders.

In a nationwide recap of third-quarter sector performance, CB Richard Ellis said the office market was simply "another quarter closer to the bottom." In its annual emerging trends report, released in November, the Urban Land Institute said rents would fall and vacancies would rise this year, and a "lackluster" economic and job recovery means that the CRE market "probably cannot gain much traction until late 2011 or 2012." And for struggling property owners, the report said that this year "will be the worst time for investors to sell" in the report's 30-year history.

Kornberg and others say the key will be job creation, because it drives everything in CRE. "If we can't create jobs, we won't have demand for space."

Unfortunately, the job outlook is shaky. Future hiring is expected to grow much more slowly than recent job firing. For example, in the 12 months ending this past October, employment in Minnesota fell by 100,000 workers—or about 4 percent of total employment, according to state figures. If job growth rebounded to equal the state's historic average (just over 1 percent annually), it would take almost four years for employment to regain its October 2008 levels. Unfortunately, forecasts by the Federal Reserve Bank of Minneapolis and other organizations predict much more sluggish employment growth in coming years (see the 2010 employment forecast on page 11). That doesn't bode well for vacancy rates, rent and new CRE development.

Compounding the problem is an abundance of "shadow space"—space that is leased but underutilized—that will need to be absorbed before real net absorption happens. Many firms have slashed employment and production, which means they have space available to grow operations once the economy and hiring kick back in. A report this past summer by Colliers said that shadow space could delay real recovery by 12 to 24 months.

Still, some sources are guardedly optimistic. Kornberg feels that the CRE problem is both smaller and simpler than the subprime mortgage disaster. "The degree of lunacy in subprime got way ahead of the lunacy of CRE," he said. Maturity default is a real problem for CRE, he said, but it's easier to deal with than the subprime mess, which gave home loans to some buyers who never had the means to pay their bills.

Moreover, lenders literally own part of the CRE problem, unlike subprime home loans that were sold by lenders into secondary markets. That means lenders have to worry about preserving the value of their collateral—commercial property. As a result, "I am not seeing a wave of maturing loans default," Kornberg said. "I have to feel that way, or I wouldn't be able to get up in the morning." Instead, he predicts a wave of loan extensions because, as one of his peers told him, "a rolling loan gathers no loss."

"Have we hit bottom? No," said Kornberg. But, he added, unlike what many once believed, "we're not going into the chasm." f

Associate Economist Daniel Rozycki and Economist Mark Lueck contributed data and analysis to this article.

CRE: The cracked glass slipper?

CRE exposure and delinquencies are on the rise for Ninth District banks, but the full fallout is difficult to gauge

By RONALD A. WIRTZ
Editor

It's a common assumption that commercial real estate represents the proverbial "other shoe" for the banking industry, and that CRE portfolios are poised to reclobber banks after many had only begun to recover from a deep recession and meltdown in housing markets.

For a number of reasons, it's hard to say how closely the health of the banking sector is tied to the commercial real estate market. Without doubt, the banking sector will experience—and is already seeing—fallout from the CRE slump. A notable number of banks have portfolios that exceed regulator guidelines for CRE concentration, particularly for construction and land development loans. In tandem with that trend, delinquency rates for all types of CRE loans are rising.

But it's difficult to gauge or predict bank health based on the current and expected performance of the broader CRE market. For starters, the CRE boom was financed by a number of different sources. The banking industry (including savings institutions) is the single largest holder of outstanding commercial mortgage debt, with about $1.4 trillion of the $2.5 trillion owed nationwide, according to December flow of funds data from the Federal Reserve Board.

A little less than one-quarter of outstanding debt is held in so-called commercial mortgage-backed securities (though virtually no new CMBS debt has been generated since 2007). Life insurance firms have about 10 percent of commercial mortgage debt, and the remaining amount is held by a hodgepodge of sources, including the federal government, real estate investment trusts, finance companies and pension funds.

Unfortunately, no similar estimates exist for CRE financing in the Ninth District, so it's difficult to say how large the CRE pickle jar is for district banks or what submarkets are most exposed. That's not a small matter, given the fact that the annual value of retail CRE transactions in the Twin Cities rose almost 20-fold just from 2001 to 2006, to more than $3 billion, while office CRE transactions rose eightfold during the same period, to $2 billion, according to data from Real Capital Analytics.

While CRE borrowers may experience deterioration in their financial condition, many continue to be creditworthy customers who have the willingness and capacity to repay their debts. In such cases, financial institutions and borrowers may find it mutually beneficial to work constructively together.

Sibling rivalry?

Within a range of other banking metrics, the scope and nature of the CRE problem is both better and worse than its residential housing predecessor. The district's large banks—those with more than $10 billion in assets—have comparatively low CRE exposure, according to third-quarter Call Report data from the Federal Deposit Insurance Corporation.

But potential problems from CRE are much more widespread among smaller community and regional banks that predominate in the Ninth District. For example, total outstanding CRE debt held by banks with less than $10 billion in assets has more than doubled in real terms since 2000, to $33 billion. Residential loans (traditional mortgages and home equity loans) among this group have also risen, but more slowly, and total about $18 billion (see Chart 1).

Exposure at some banks has crossed certain thresholds that regulators consider prudent; about one in seven banks in the Ninth District have loan concentrations in this sector that exceed bank regulator guidelines.

For example, regulators (including the Federal Reserve) deem a bank's portfolio concentrated if it includes CRE loans in excess of 300 percent of the bank's total risk-based capital. Such concentration can be potentially dangerous because the lack of loan diversification puts a bank in harm's way should an economic shock hit the sector. A total of 39 banks in the district exceeded this 300 percent threshold at the end of September, with the highest percentage in Montana and Minnesota (see Chart 2). Exceeding this threshold does not imply imminent demise for a bank. But it is an indicator of enhanced risk, evident by the fact that regulators require more sophisticated and enhanced management practices from these banks.

This CRE loan concentration also is more prevalent among smaller banks. Whereas the housing debacle slammed the nation's largest banks—with assets in the hundreds of billions—no district bank that exceeded the 300 percent ratio had assets exceeding $1 billion in assets, and the large majority were much smaller than even this level.

These concentration figures also do not include so-called owner-occupied nonfarm-nonresidential property—in essence, commercial mortgages to firms that own their office or manufacturing plant, rather than leasing space from a property owner. The rationale for this exclusion is that repayment for such loans does not depend on the swings in supply and demand for commercial buildings themselves; rather, repayment depends on the performance of the company and the broader economy.

This bit of methodological minutia offers both good and bad news. First, this owner-occupied segment of commercial mortgages is big, making up 30 percent of the outstanding CRE debt held by district banks (see Chart 3). That means a large share of CRE lending is, technically speaking, of less concern to regulators in terms of concentrated risk in this sector.

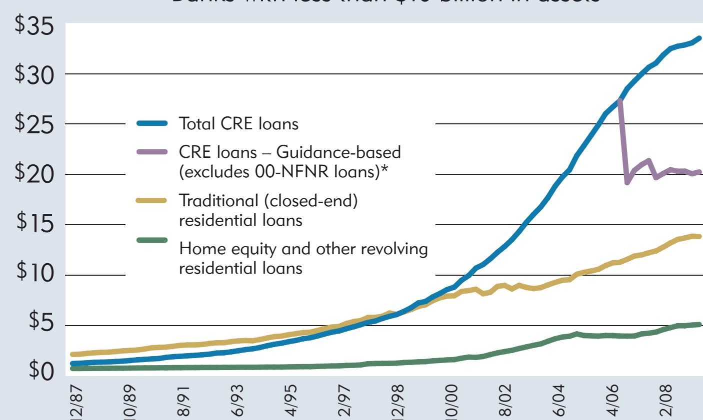
At the same time, loan performance among owner-occupied borrowers nonetheless has some influence on supply and demand in the broader CRE market and has been worsening; the delinquency rate for owner-occupied commercial loans is currently higher than for nonowner-occupied property loans and is on a steeper trajectory (see Chart 4).

Another indicator of heightened risk is concentrated lending in construction and land development (CLD). Regulators become concerned when such loans amount to 100 percent or more of a bank's total risk-based capital. The lower guidance ratio for this measure is due to the fact that these loans usually don't generate income until completed, so they can be particularly risky if real estate markets sour. And even more district banks—86, in all—had crossed this guidance threshold as of the end of September, with Montana and Minnesota banks again seeing the largest share. Also notable is the fact that delinquency rates for CLD

Chart 1:

District CRE loans growing faster than housing

Merger-adjusted, billions of 2009 dollars
Banks with less than $10 billion in assets

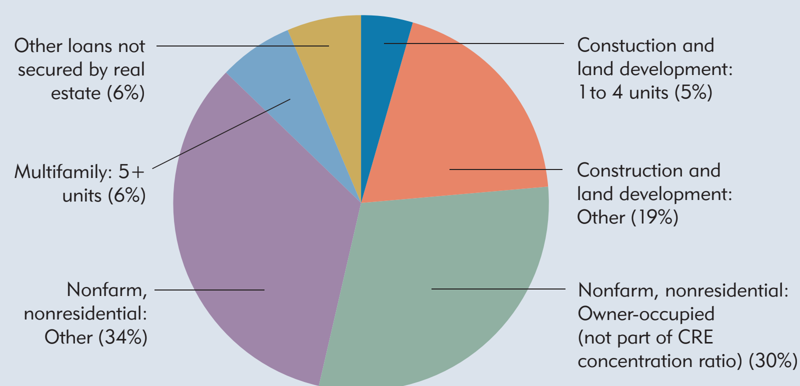


*2006 regulator guidance on CRE loan concentration excludes loans for owner-occupied, nonfarm nonresidential real estate, which is why that segment is split off separately starting in the first quarter of 2007.
Source: Reports of Condition and Income (Call Reports), FDIC

Chart 3

Outstanding loans by CRE sector

Ninth District banks, as of Sept. 30, 2009

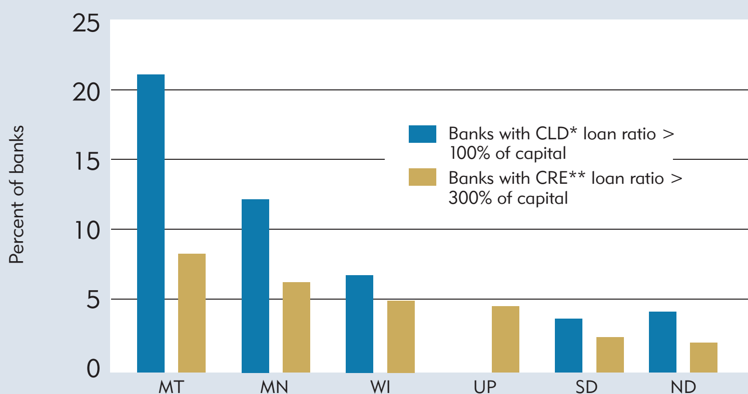


Source: Reports of Condition and Income (Call Reports), FDIC

Chart 2

CRE & CLD concentration highest in Montana and Minnesota

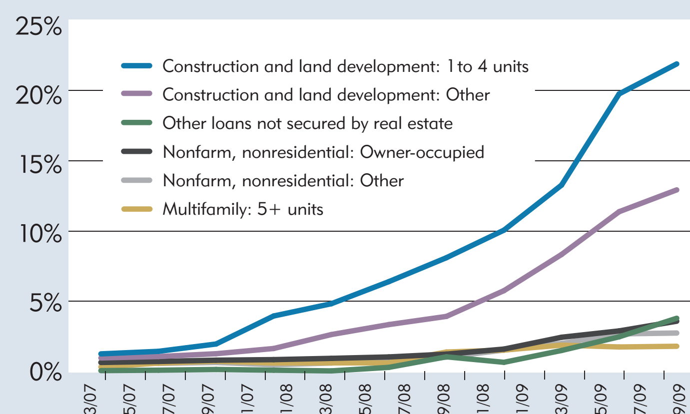
CRE loan ratios compared with 2006 regulator guidance



*Construction and land development; the 100 percent concentration ratio includes residential and nonresidential loans.
**Commercial real estate; the 300 percent concentration ratio includes all CRE loan categories except nonfarm, nonresidential owner-occupied loans.
Source: Reports of Condition and Income (Call Reports), FDIC

Chart 4

District bank CRE delinquency rates rising



Source: Reports of Condition and Income (Call Reports), FDIC

loans have risen much faster compared with other CRE loans.

Combined, 101 of the 713 commercial banks in the district exceeded at least one of these guidelines; a total of 13 banks violated both guidance measures, with almost half (six) of them in Montana.

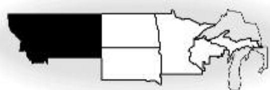
With rising delinquency rates as well as a looming threat of maturity default for some loans (discussed in the cover article), lenders and borrowers alike received some helpful guidance from regulators last fall. First, the IRS approved a rule change that allows CRE borrowers to begin negotiating loan modifications before the loans themselves go bad. Previously, such modifications carried tax penalties, typically delaying such negotiations until default was imminent.

Then in late October, bank regulatory agencies (including the Federal Reserve) jointly announced guidelines to help banks "prudently" renew and restructure troubled CRE loans without intensifying the underlying risk to bank capital. The hope is that this change will better align the desire of both regulators and bankers to lift the banking sector to safer ground while loosening credit to the CRE market.

In a joint statement, regulators said new guidelines for loan workouts "recognize that financial institutions face significant challenges when working with commercial real estate borrowers. … While CRE borrowers may experience deterioration in their financial condition, many continue to be creditworthy customers who have the willingness and capacity to repay their debts. In such cases, financial institutions and borrowers may find it mutually beneficial to work constructively together." f

Associate Economist Daniel Rozycki and Economist Mark Lueck contributed data and analysis to this article.

MONTANA



Telcos blast cable broadband plan

Gov. Brian Schweitzer's backing of a cable firm's bid for federal economic stimulus funds to expand high-speed Internet service in rural areas has drawn sharp criticism from telephone companies and their chief regulator in the state.

Bresnan Communications, a cable TV and Internet provider, has proposed building a 1,885-mile fiber-optic network to pipe broadband to seven Indian reservations and other underserved areas of the state. Schweitzer's office singled out the Bresnan project from more than a dozen competing proposals as a "top priority," urging the U.S. Department of Commerce to fully fund it at a cost of $70 million.

Telephone companies blasted Schweitzer for endorsing the Bresnan plan, charging that it would duplicate the firms' existing long-distance fiber-optic lines in rural areas, including the Indian reservations. The Montana Public Service Commission also criticized Bresnan's proposal, saying that it failed to increase critical "last-mile" broadband access for homes and businesses.

Officials with Bresnan and the state's Indian tribes defended the project. They said the new network would eventually provide faster, cheaper broadband Internet service to Indian reservations, fostering business development and boosting employment.

Federal officials were expected to decide by January which projects in the state will receive stimulus funds.

Farm groups object to BSNF rate hike

Balking at a proposed increase in rail freight rates, two Montana farm groups plan to take their grievances to mediation with the Burlington Northern Sante Fe railroad.

BNSF and the farm groups—the Montana Farm Bureau Federation and Montana Grain Growers Association—agreed earlier this year to mediate and arbitrate disputes over grain freight rates in the state. Such a dispute arose when a Shelby-area farmer objected to BNSF's proposal to raise the rate on Shelby-to-Portland, Ore., grain shipments by about 3 cents per bushel.

Montana farmers have long expressed concern about lack of competition inflating rail shipping rates. BNSF, which is being acquired by billionaire investor Warren Buffett, controls more than 90 percent of the rail miles in the state.

—Phil Davies

A call to arms

Gun sales surged during the recession, but lately have slowed

One view is that perceptions of increased crime have driven up gun sales, while another theory attributes the sales spurt to worries over potential federal legislation limiting access to guns and ammunition.

By JOE MAHON
Staff Writer

There's an old joke in the gun and ammunition business that firearms are a countercyclical asset. When the economy sours, the reasoning goes, fear of crime makes people reach for comfort—a pistol, rifle or shotgun with which to fend off the desperate and preserve life and property.

It's debatable whether economic downturns increase crime (see the March 2009 *fedgazette*). But there's plenty of anecdotal evidence that sales of firearms and ammunition have risen during the current recession. In the first quarter of last year, gun maker Smith & Wesson reported a 30 percent increase in profits. Winchester Ammunition's earnings doubled in the second quarter, and during the same period, Alliant Techsystems, a Twin Cities-based aerospace and defense firm, saw profits on its consumer gun and ammunition products rise 25 percent. "There's been unprecedented demand for ammunition sales on our sport ammunition line," said Alliant spokesman Bryce Hallowell.

The media have aired numerous stories about soaring gun and ammunition sales and ammo shortages in some areas of the country last year. In many accounts, the underlying force is not economics, but politics—namely, fears that a Democratic administration in Washington will restrict access to firearms.

Are guns really flying off the shelves, and if so, why? It turns out that gun sales nationwide and in the Ninth District did increase in 2009. Although recession-driven fear of crime may have played a role, the more likely explanation is concern about a potential government crackdown on guns. However, there's evidence that in recent months the rush to stock up on guns has abated as continuing economic woes have crimped discretionary spending.

Jumping the gun

Although Americans spend a lot of money on firearms and ammunition, tracking trends in gun sales isn't straightforward. Federal tax receipts from gun and ammo sales show that sales increased sharply last year nationwide—52 percent in the second quarter of 2009 compared with the same quarter a year earlier.

But U.S. Treasury tax figures aren't available for individual states, and in general state-level data on gun purchases are spotty; no district state requires registration of firearms, and only Minnesota requires a permit to buy a firearm.

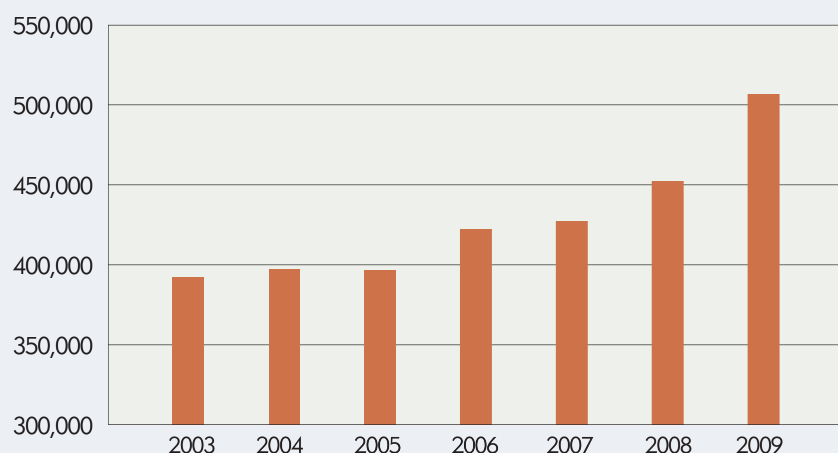
There is one federal data set that serves as an indicator of the volume of gun and ammunition sales. Since passage of the Brady Handgun Violence Prevention Act in 1993, all gun buyers have been required to pass a criminal background check. In the late 1990s, the FBI automated these checks in its National Instant Criminal Background Check System (NICS). The NICS database tallies all transactions monthly and tracks them at the state level.

The FBI takes pains to point out that NICS doesn't tally firearm sales. A gun store customer might purchase several guns, or decide to buy none at all. A buyer who has already passed a previous background check at a given store can buy additional guns without adding to the numbers. And if a prospective buyer fails a background check, there's no sale.

But the NICS numbers provide a rough proxy for overall firearms demand. Since any first-time gun buyer has to pass a background check, the numbers should reflect greater public interest in buying firearms.

The data imply that firearms activity has indeed risen over the past year or so (see chart on page 9). Nationally, the number of background checks through September 2009 (the most recent month for which data were available) increased 20 percent over the same period a year earlier.

In the five-state region, the number of firearm background checks rose by nearly 77,000, or almost 13 percent. Background checks also increased in every district state, but the level of increase varied greatly. South Dakota saw the biggest jump of more than 17 percent, while the rise in checks in North Dakota was minimal—less than



2 percent. Minnesota's increase was more typical at just under 13 percent, similar to increases in Montana and Wisconsin.

Interest in purchasing firearms has cooled in recent months, however. Last summer, the number of background checks nationwide continued to increase, but at a slower rate than in late 2008 and early 2009. During the summer in Minnesota and Wisconsin, the number of background checks was flat year over year, and the count fell slightly in September in Minnesota.

These figures suggest that demand for guns was high, at least through last spring—in marked contrast to falling demand for other consumer goods such as autos, electronics and clothing during the recession.

Loaded for bear

Various theories have been put forward for the apparent surge in firearms activity during the recession. One view is that perceptions of increased crime have driven up gun sales, while another theory attributes the sales spurt to worries over potential federal legislation limiting access to guns and ammunition. While these two explanations aren't mutually exclusive, there's more evidence for the latter view.

Curtis Bjorndahl, manager of Precision Tactical Firearms, a manufacturer of rifles and pistols in Billings, Mont., espouses the fear-of-crime theory. "Right before recessions, people tend to purchase weapons," he said.

However, the NICS data, which go back to 1998, only weakly support this idea. During the last recession in 2001, the number of background checks rose about 5 percent nationwide, and district states saw similar increases. That may or may not be significant; the NICS record shows comparable increases in nonrecession years as well.

One rough indicator of increased anxiety about crime is applications for permits to carry concealed handguns. People who seek to carry weapons are presumably concerned about personal assaults.

Counts of concealed-carry permits aren't available for all district states, but data for Montana and Minnesota show that more people in those states are packing heat. The number of permits issued by the state of Montana through October 2009 doubled compared with the same period in 2008, increasing the total number of permits by about 23 percent. Preliminary numbers for Minnesota through November indicate that permit applications have more than doubled from levels in recent years.

But an increase in concealed-carry permits doesn't necessarily mean that people are buying more guns and ammunition for home defense; some who already own guns may simply want to carry their weapons on their persons.

A stronger case can be made for the theory that consumers stocked up on weaponry because they were concerned about Second Amendment restrictions by a White House and Congress controlled by Democrats. The number of NICS background checks nationwide jumped 50 percent in November 2008, the month of the presidential election. Every district state saw an increase that month, ranging from 21 percent in Wisconsin to 46 percent in Minnesota.

But the slowdown in background checks since summer, both nationally and in the district, suggests that such concerns were transitory. Despite talk earlier this year about reinstating a ban on assault weapons, the Obama administration hasn't taken steps to restrict gun or ammunition sales.

Aiming for lower sales

At the height of the gun rush in late 2008 and early 2009, Mark Koscielski couldn't keep up with demand at his gun shop in south Minneapolis. "At one point, we had over 500 guns on back order," he said, attributing the spike in business to fear of gun control legislation and ammunition hoarding in response to spot shortages. But last fall, as the recession dragged on, sales fell. "Lately, business has been pretty poor," Koscielski said.

The falloff in sales at Koscielski's store—and the slowdown in NICS background checks last fall—may be due to the long recession and fading fears about government restrictions on firearms. Guns and bullets are discretionary purchases; many people hurt by the recession may have decided that they didn't need to buy a gun after all.

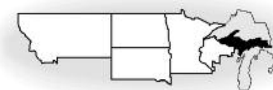
In a recovering economy, national gun sales, as measured by NICS background checks, are likely to settle down to prerecession levels—annual increases of about 3 percent to 5 percent. That is, unless the federal government mounts a gun control initiative, Koscielski observed; such a move could trigger another run on gun stores.

However, over the long term, gun and ammunition sales in the district are likely to fall because of demographic trends working against gun ownership. There are signs that participation in hunting—a major driver of gun sales—is on the wane. For example, firearm deer hunting licenses issued in Wisconsin for the 2009 season declined 12 percent through October, compared with the same period in 2008.

Particularly distressing for gun makers and dealers is a drop in the number of young hunters, who represent the future of the sport. A national survey by the U.S. Fish and Wildlife Service found that in 2006, only 4 percent of 18- to 24-year-olds hunted, compared with 14 percent in 1980. In Minnesota, the number of hunting licenses sold to people younger than 40 fell about 20 percent between 2000 and 2008.

"I think you're going to see a lot more campaigning trying to get more youth involved [in hunting]," said John Monson, owner of Bill's Gun Shop in Robbinsdale, Minn. "We're going to have to continue to do that, or we will lose volumes." f

UPPER PENINSULA



Another renewable on the energy menu

Marquette County got a shot in the arm when Cliffs Natural Resources gave final approval in mid-November for a renewable fuels plant that will convert wood and agricultural biomass into a combustible cube.

The plant will be housed in two converted aircraft hangars at Sawyer International Airport. Cliffs, the owner of two taconite mines in the Upper Peninsula, plans to spend about $19 million to get the project running and hopes to have the plant operating by the middle of this year, according to local reports.

The plant is expected to produce about 150,000 tons of the biomass cube, which will have the same energy content as coal with significantly less pollution and will be produced from local feedstock. Even before the first briquette is produced, the Marquette Board of Light and Power agreed to purchase 60,000 tons to generate steam for energy production. Cliffs will also use some of the production at its mines.

The idea of burning wood for power is already well established in the state, which has six wood-burning power plants (all in lower Michigan) that produce one-third of the state's renewable energy, according to an industry group. More efforts are under way to encourage biomass energy. Last fall, biomass suppliers to a small electricity plant in L'Anse, in the north-central U.P., became eligible for federal subsidies to make the cost of gathering and transporting biomass more feasible.

A close look at the Big Drink

For Michigan Tech University, this is the big one that didn't get away.

This past fall, the university received approval from the state Legislature to break ground on a new $25 million, 49,000-square-foot building that will house the Great Lakes Research Center.

The center, located in the Keeweenaw Peninsula at the tip of the Upper Peninsula, will house a range of research facilities, including labs for fisheries, sediment processing and mass spectrometry (to sample and analyze sediment), hydrology, exotic species and meteorology. This diversity of research will allow the center to study a broad range of disciplines and pressing environmental issues in the Upper Great Lakes, including habitat destruction and invasive and native species.

—Ronald A. Wirtz

A slow recovery is under way

By ROB GRUNEWALD
Associate Economist

TOBIAS MADDEN
Regional Economist

The national and district economies appear to have emerged from the recession, and a slow recovery is under way. According to the Minneapolis Fed's forecast model and business outlook poll, the district economy is expected to gradually mend in 2010. However, not all areas of the economy are anticipated to pull through with similar strength, and downside risks continue to linger. On the one hand, an optimistic outlook for agriculture, gains in manufacturing activity, a modest improvement in consumer spending and better residential real estate conditions will aid the recovery. On the other hand, slow residential and nonresidential construction and weak labor markets will continue to drag on the economy.

Longest recession since WWII comes to an end

While the National Bureau of Economic Research has yet to determine specifically in which month the recession ended, most economists agree that at least by the third quarter (July through September) the national economy lifted itself out of the longest recession since World War II. Estimates show that gross domestic product grew at an annual rate of 2.8 percent in the third quarter, the first positive GDP growth since second quarter 2008.

As the national economy is slowly pulling out of the recession, the district economy is following suit. Manufacturing activity began picking up in the district during the second half of 2009. According to Creighton University's survey of manufacturers, activity in Minnesota grew in August through November after declining for 12 consecutive months. On average, manufacturing also grew in North Dakota and South Dakota during the past few months; activity didn't drop as sharply or as long in these states compared with Minnesota. According to the Minneapolis Fed's survey of manufacturing, respondents across the district expect new orders and production to grow in 2010 (see related story on page 15).

Consumer spending has shown some signs of recovery. Since the recession began, national personal consumption expenditures were down or grew only slightly. However, during the third quarter, personal consumption grew 2.9 percent, helping to boost overall growth, as consumer spending represents 70 percent of GDP. Monthly retail sales also posted increases in October and November.

Despite the increase in consumption, personal savings as a percentage of disposable personal income was 4.5 percent in the third quarter—the fourth quarter in a row in which the savings rate exceeded 3 percent. While higher savings results in less consumption in the current quarter, it does suggest that households are strengthening their financial position to support more consistent economic growth in the longer run.

Holiday spending was constrained, but didn't show the deep declines of a year earlier. A preholiday spending survey of households in the Minneapolis-St. Paul area conducted by the University of St. Thomas indicated that respondents expected to spend 3 percent less than in 2008. This decrease follows an 11 percent anticipated decrease in the preceding holiday shopping season. District retailers generally reported steady traffic during the holiday season, but modest increases in sales. Respondents to the business outlook poll (see related story on page 14) and the survey of manufacturers were more likely to predict decreases in area consumer spending than increases during 2010, but they were more optimistic than last year.

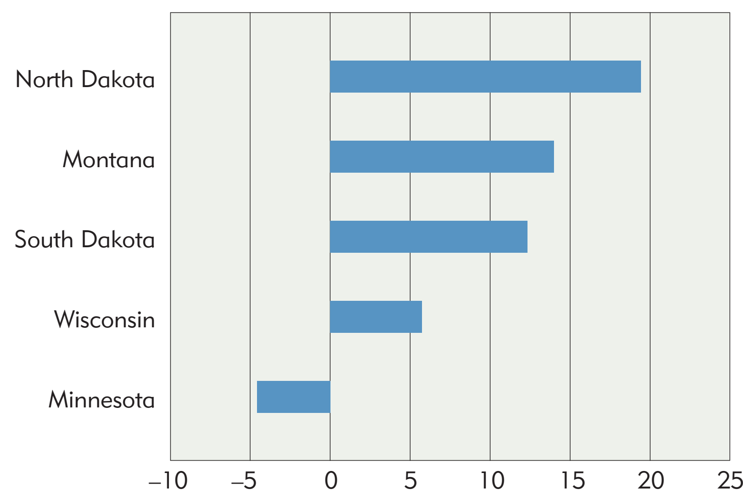
Following slight growth in 2008, district personal income dropped during 2009, except for a slim gain in South Dakota. Meager growth in personal income dampens consumer spending. The forecasting model points to moderate increases in personal income during 2010 (see page 11), while business outlook poll respondents expect wage and salary increases in their communities to stay below 3 percent.

However, as personal income slipped in 2009, consumers did not have to face price increases at the checkout line; in fact, they were more used to encountering price decreases in 2009. The consumer price index was down 0.6 percent for the first 11 months of 2009 compared with a year earlier, which means the annual CPI average for 2009 will likely finish lower than a year earlier for the first time since 1955.

Home sales up, building down

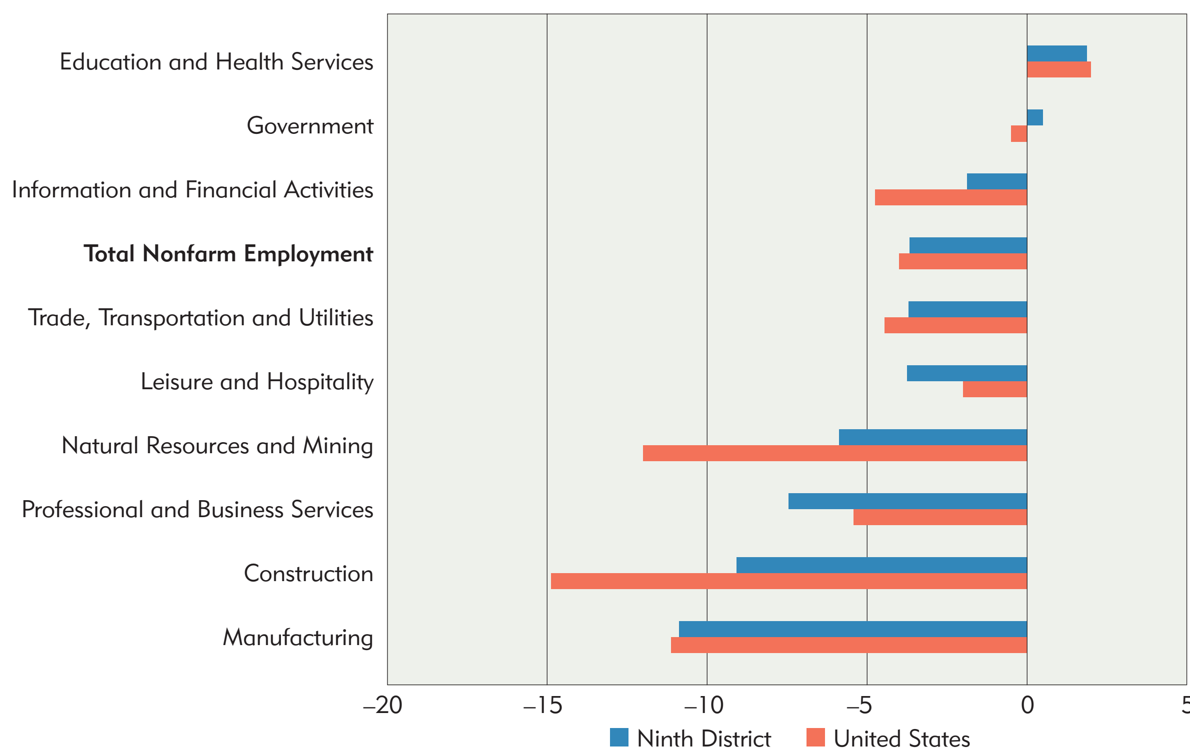
Residential real estate markets showed signs of recovery, as existing home sales increased in all district states during the third quarter compared with a year ago (see Chart 1 above). The exception

CHART 1 **Home sales pick up in most district states**
Percent change in existing home sales from a year earlier, third quarter 2009



Source: National Association of Realtors

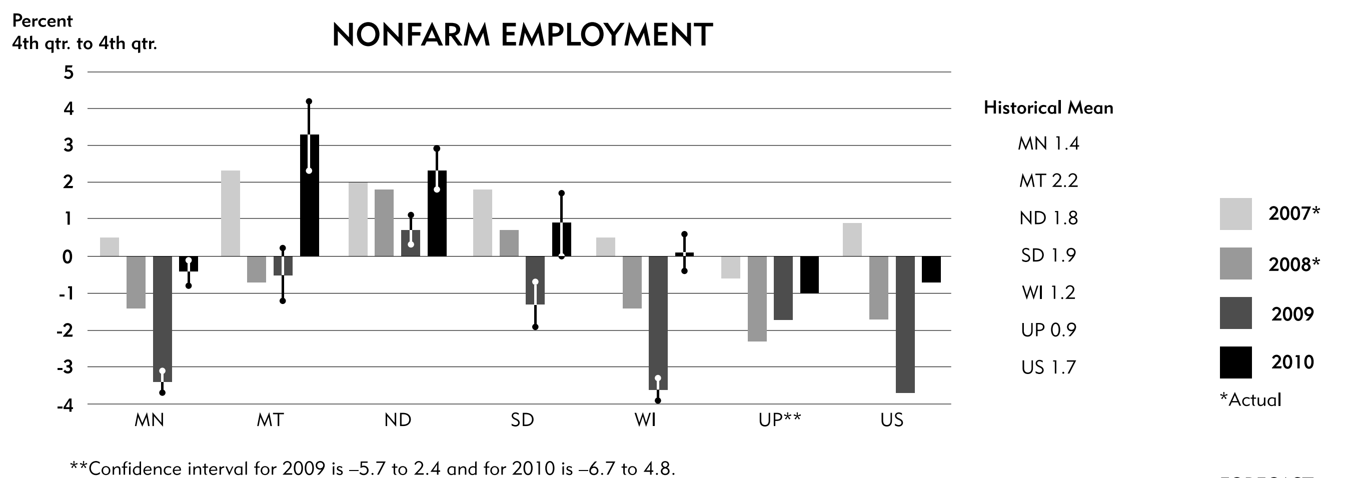
CHART 2 **Employment decreased in almost all industries**
Nonfarm employment, percent change from a year earlier, October 2009



Source: Bureau of Labor Statistics

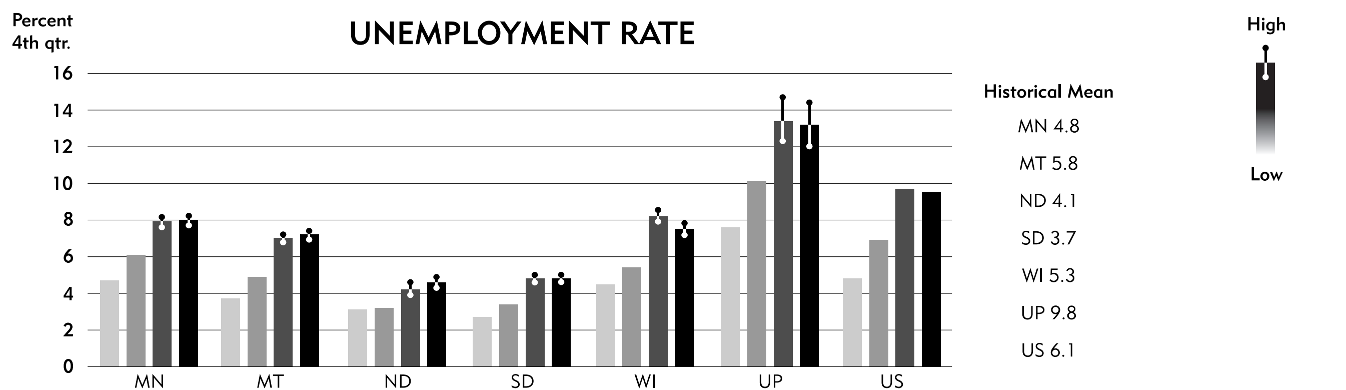
District Forecast

Nonfarm employment levels are expected to recover in the western part of the district, but continue lackluster performance in the east. Employment decreased from 2008 to 2009 in all states, except North Dakota, which was the only district state that did not record a quarterly year-over-year decrease in nonfarm employment during the recession. In 2010, employment will increase in Montana and the Dakotas, but remain level or decrease slightly in Minnesota, Wisconsin and the Upper Peninsula of Michigan. Employment growth rates in Montana and North Dakota are expected to exceed historical averages.

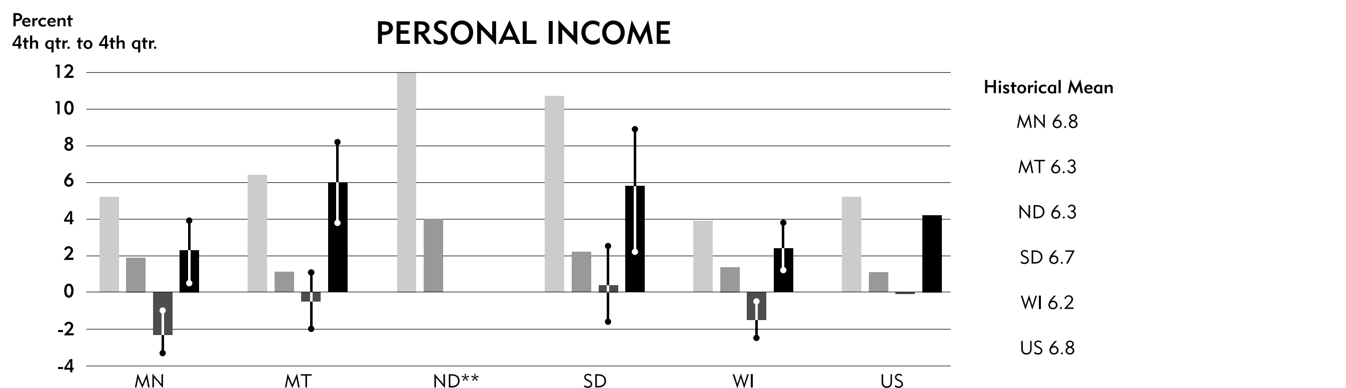


**Confidence interval for 2009 is –5.7 to 2.4 and for 2010 is –6.7 to 4.8.

Unemployment rates are predicted to remain at relatively high levels. In 2009, unemployment rates increased in all states from 2008 levels and were far above historical averages. The average increase was 2.1 percentage points. In 2010, unemployment rates will increase slightly in Minnesota, Montana and North Dakota, remain level in South Dakota, and decrease somewhat in Wisconsin and the Upper Peninsula. As in 2009, unemployment rates in 2010 will exceed historical averages.

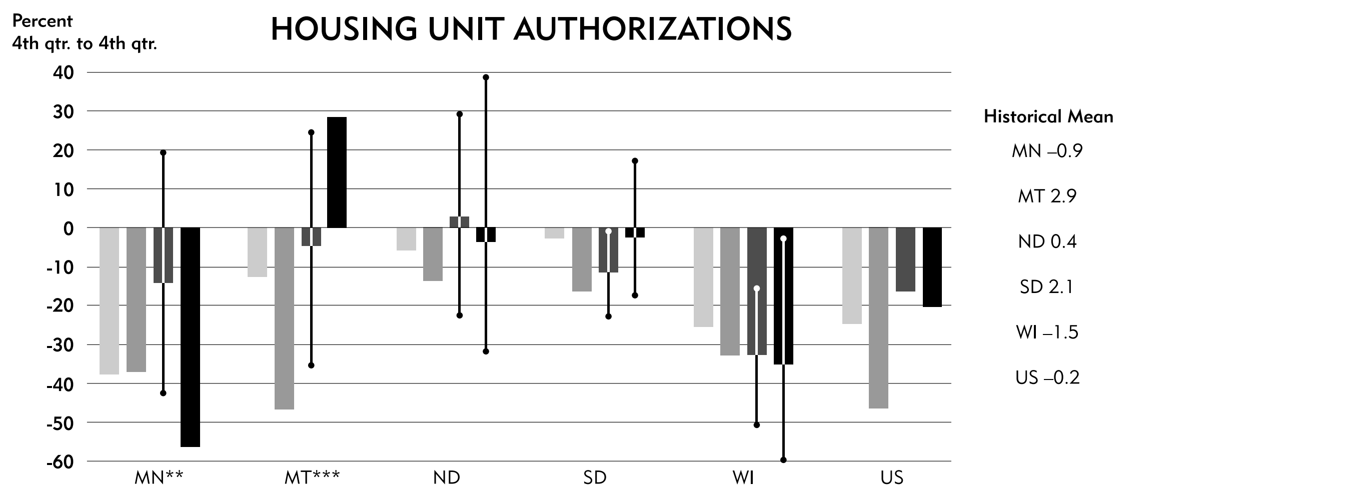


Personal income is expected to rebound moderately. During 2009, personal income decreased throughout the district except in South Dakota, where personal income increased slightly. In 2010, personal income is expected to grow in all areas except North Dakota. The predicted increases are close to historical averages in Montana and South Dakota, but are relatively modest in Minnesota and Wisconsin. The large expected decline in income in North Dakota is likely attributed to the volatile nature of farm income.



**Estimate for 2009 is –14.7, confidence interval –27.9 to –0.2.
Forecast for 2010 is –16.9, confidence interval –32.9 to 5.2.

The decline in housing units authorized is predicted to slow in some areas. In 2009, authorizations decreased in all district states except North Dakota, where authorizations increased faster than historical averages. In 2010, housing units authorized are predicted to pick up substantially in Montana, while decreasing slightly in the Dakotas. The forecasting model shows authorizations dropping steeply in Minnesota and Wisconsin, but these predicted decreases are likely due to the unusual behavior in current data combined with the statistical properties of the forecasting model. In Minnesota and Wisconsin, housing units authorized have not only dropped sharply during the past few years, but they are also below levels observed over 30 years ago. Since forecasting models typically rely on long-term and recent trends, it is not surprising that the model points to a continued drop. At some point, population and market pressures will spur demand for housing, but the Minneapolis Fed's model, as with forecasting models generally, will have difficulty predicting when that turning point will occur.



**Confidence interval for 2010 is –96.7 to –11.2.
***Confidence interval for 2010 is –7.9 to 90.9.

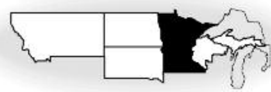
was Minnesota, but more recent data for the Minneapolis-St. Paul area show that total home sales were higher during November compared with a year ago. Sales during 2009 were spurred by relatively low prices and interest rates, and the first-time home buyer tax credit. Home prices during the third quarter were lower in Minneapolis-St. Paul and Sioux Falls and were up only slightly in Fargo.

The increase in home buying activity hasn't translated into increases in building activity. District housing units authorized year to date through October were down 26 percent compared with a year earlier. The forecasting model points to continued declines in housing units authorized during 2010, except for an increase in Montana. More respondents to the business outlook poll expect housing starts in their own communities to decrease (48 percent) than increase (17 percent) in 2010. However, this result was more optimistic than last year's poll, when 80 percent anticipated decreases and only 4 percent predicted increases.

District commercial building also decreased during 2009, as vacancy rates increased and announcements of new development projects came to a near halt. As firms downsized their workforces during the recession, demand for office, manufacturing and retail space decreased as well. Difficulty obtaining credit has also constrained new development. Slow commercial building activity is expected in 2010.

Continued on page 12

MINNESOTA



Bound for (out of state) college

There's good news and bad news for Minnesota higher education. In a nutshell, college enrollment rates have never been higher, and more students than ever are choosing out-of-state schools, according to a December analysis by the Minnesota Office of Higher Education.

In 2008, the state's fall college participation rate for graduating high school seniors broke the 70 percent mark for the first time ever—a significant jump over the 65 percent rate seen just five years earlier.

However, all of that growth funneled to out-of-state institutions. A total of 50.8 percent of high school graduates chose an in-state college in 2008, which is unchanged from 2003. At the same time, the percentage choosing to attend college out of state increased from 14.7 percent to 19.4 percent. Most of those students are attending college in a neighboring state; according to the report, the three most popular college destinations for Minnesota students in 2008 were North Dakota State University, the University of North Dakota and the University of Wisconsin-Madison.

Checks in the mail (next month)

The recession has forced the State of Minnesota to get creative to stay ahead of the bill collectors.

State tax collections have come in well short of expectations. In the third quarter of last year, income taxes came up more than 5 percent, or $93 million, short of projections. Sales taxes were down $20 million. Corporate taxes came in $52 million above expectations, but were below the same period last year by a similar amount.

The resulting cash flow problem has forced the state to delay more than $128 million in corporate tax refunds to 461 companies and another $12 million in sales taxes to at least 350 firms, according to news reports. The delay is expected to be a couple of weeks—short of the 90-day delinquency that would require the state to also pony up interest payments.

The problem is an ongoing one. In November, the state's commissioner of management and budget told the Legislature that short-term borrowing up to $1 billion might be required in the coming quarters to make sure the state has sufficient cash flow while the economy gets back on its feet.

—Ronald A. Wirtz

Outlook from page 11

Weak labor markets continue in 2010

In October 2009, district nonfarm employment was 3.7 percent lower than a year ago; the decrease nationally was 4 percent. Losses occurred in a broad range of industries. Those with the largest job losses in the district included manufacturing (–10.8 percent), construction (–9.1 percent) and professional and business services (–7.4 percent). The only sectors with increases were education and health services (1.8 percent) and government (0.4 percent). (See Chart 2 on page 10.)

Unemployment rates increased across the district during 2009. Nationally, the unemployment rate reached 10.2 percent in October, then settled back to 10 percent in November. Unemployment rates in most district areas remained below the national rate during 2009; the exception was the Upper Peninsula of Michigan. The U.P. historically has a higher unemployment rate than the nation, but recently it also has been adversely affected by economic conditions in the rest of Michigan, particularly companies associated with the auto industry.

Looking forward, the Minneapolis Fed's forecasting model predicts employment increases during 2010 in Montana and the Dakotas, but the recovery in the district's eastern states may stall on job increases until 2011.

Meanwhile, unemployment rates will remain at relatively high levels during 2010. However, relatively high unemployment rates during a recovery reflect more than low employment. Increases in the unemployment rate are caused not only by net job losses, but also by gains in the labor force as workers who previously gave up looking for work begin to look for jobs again as prospects for employment improve. When the pace of layoffs slows, an increase in unemployment is a likely sign that workers who had given up looking for a job are now re-entering the workforce.

Federal stimulus dollars still in play during 2010

Once fully implemented, the American Recovery and Reinvestment Act will inject $787 billion into the economy in the form of tax credits, expanded unemployment insurance benefits and investments in transportation and education, among other areas. It is difficult to assess the impact of government stimulus on national income accounts. However, the federal package did reduce the blunt of the recession on state and local government budgets.

The size of federal stimulus awards to district states relative to state GDP in 2008 ranged from 1 percent of GDP in Minnesota and Wisconsin to 2.4 percent of GDP in Montana. As of October, the percentage of funds received by district states relative to total funds awarded ranged from 15 percent in Montana to 36 percent in South Dakota; therefore, a substantial portion of the stimulus dollars will be received by district states during 2010. Top recipients in district states include state departments of transportation and education, state university systems, water infrastructure programs and Native American tribes. However, with stimulus funds drying up in a year, state and local governments that were able to delay difficult budget decisions may be facing them again in the near future.

Milk and meat prices expected to pick up in 2010
Average farm prices

	2006/2007	2007/2008	Estimated 2008/2009	Projected 2009/2010
(Current $ per bushel)				
Corn	3.04	4.20	4.06	3.25–3.85
Soybeans	6.43	10.10	9.97	8.75–10.25
Wheat	4.26	6.48	6.78	4.65–5.05

	2007	2008	Estimated 2009	Projected 2010
(Current $ per cwt)				
All Milk	19.13	18.29	12.70–12.80	16.35–17.10
Choice Steers	91.82	92.27	82.95	86.00–93.00
Barrows & Gilts	47.09	47.84	40.81	43.00–46.00

Source: U.S. Department of Agriculture, estimates as of December 2009

Ag producers salvaged a crop in 2009; stars aligning for 2010

Ample moisture is usually a good sign for farmers, but not when they want to get in the fields. In 2009, a wet spring and fall delayed planting and harvesting. However, solid yields prevailed, and output of several major district crops was expected to increase in 2009. The large harvest combined with solid output prices and lower input costs put a smile on many farmers' faces. But meat and dairy producers were hurt, as strong input costs and lower output prices curbed profits and investment. The outlook for 2010 is upbeat with lower input costs, ample soil moisture and expected higher prices for steers, hogs and milk.

Demand for fuel increased in the fall as farmers had to dry their grain, and sporadic propane shortages were reported as a result. Late spring rains delayed planting and October rains pushed back the harvest, but yields held. The district is expected to see overall production increases in corn (2 percent), soybeans (15 percent), wheat (2 percent), dry edible peas (41 percent) and sugar beets (3 percent) compared with 2008. While 2008 saw huge price swings, prices for many crops and farm inputs such as fertilizer and pesticides were relatively flat to lower in 2009. However, propane and diesel costs increased later in the fall. Ethanol prices remained steady, as capacity and production increased.

While farmers had a good 2009, ranchers had it tough. Prices dropped for steers (10 percent) and hogs (15 percent) and plunged for milk: $18 per hundred pounds in 2008 down to about $13 in 2009. Input costs remained relatively high, and spring storms hurt the number of calves. The number of cattle on feed dropped 6 percent in 2009 from 2008.

In contrast to 2009, the outlook for 2010 is upbeat for ranchers. According to U.S. Department of Agriculture forecasts (see table), 2010 prices for cattle, hogs and dairy are expected to increase and the cost of corn and wheat is expected to decrease. Meanwhile, soil moisture conditions have improved and farmers expect lower input costs, both of which bode well for crop production and profit margins.

District trade increased with NAFTA

By TOBIAS MADDEN
Regional Economist

JESSICA RUSH
fedgazette Intern

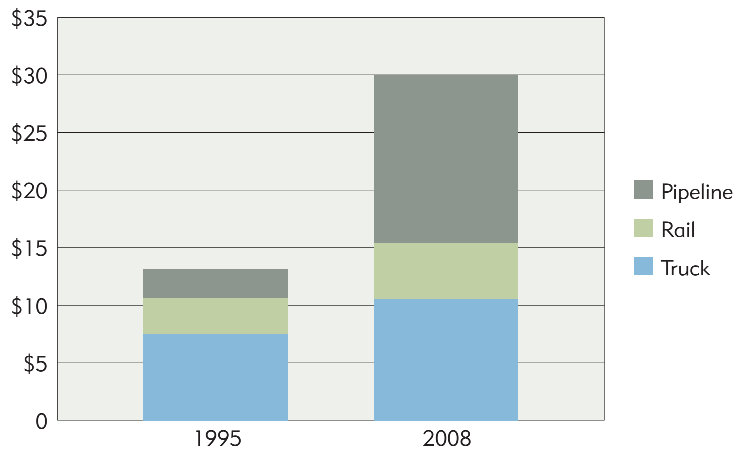
The North American Free Trade Agreement removed barriers to trade between the United States, Canada and Mexico, opening the doors for huge freight flows among the three countries. The four full states of the Ninth District experienced over $30 billion of land-based trade (primarily through pipelines, truck and rail) with Canada in 2008, a real increase of 121 percent from the start of NAFTA in 1995 (see Chart 1).

The value of freight traveling between the Ninth District and Canada has not always grown steadily over the years, mostly because trade generally follows national growth and recession trends. Trucking, for example, has been affected by the current and past recessions (see Chart 2). The value of truck freight was essentially unchanged in real terms in December 2008 compared with December 2007. Meanwhile, from 2000 to 2001 (the last recession), the value of truck freight saw a real decline of 5 percent.

Within the Ninth District, there are differences among states in mode of transportation to and from Canada (see Chart 3). Minnesota and Montana have several refineries that process Canadian oil, which is why pipelines make up about half and three-quarters of the value of trade in those two states, respectively. North Dakota transports about a third of its trade via train (mostly agricultural and energy related); it is also the state where the agriculture sector comprises 6 percent of GDP, the highest proportion of any of the district states. ■

CHART 1 **District land-based trade with Canada has grown 121 percent after NAFTA***

Billions of 2008 dollars

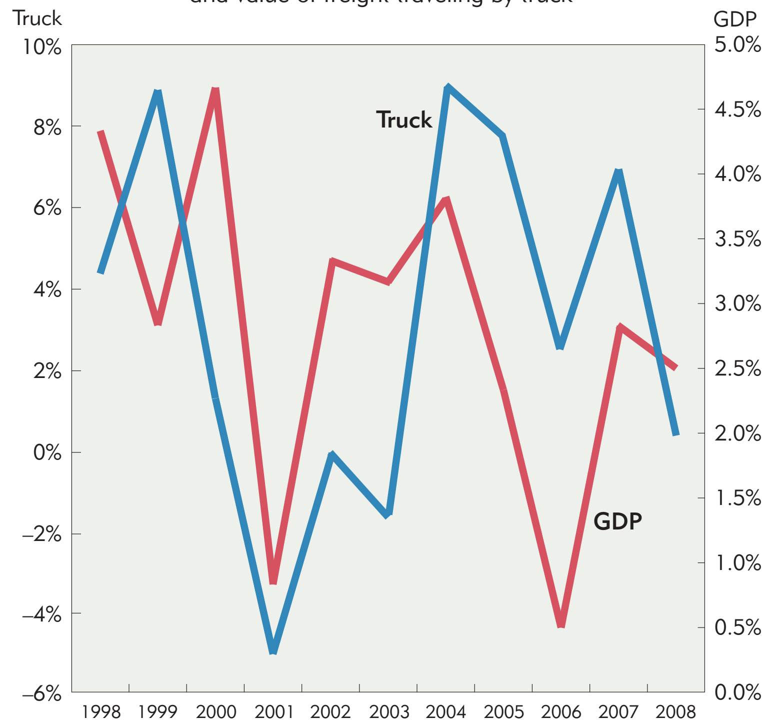


*Includes Minnesota, Montana, North Dakota and South Dakota

Source: U.S. Department of Transportation, Bureau of Transportation Statistics

CHART 2 **Truck trade and economy flow together**

Percent change in Ninth District GDP and value of freight traveling by truck*

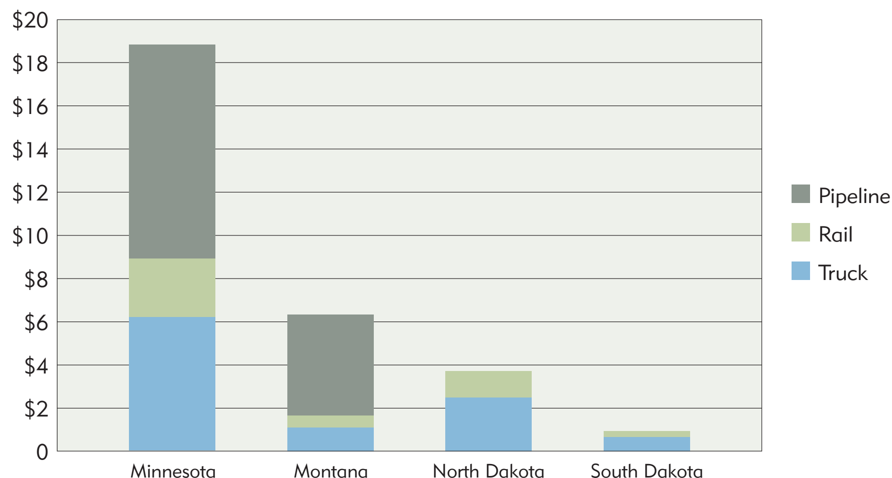


*Adjusted for inflation, includes Minnesota, Montana, North Dakota, South Dakota

Sources: U.S. Department of Commerce, Bureau of Economic Analysis and U.S. Department of Transportation, Bureau of Transportation Statistics

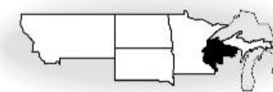
CHART 3 **Oil imports are a major factor in trade**

2008 trade, billions of dollars



Source: U.S. Department of Transportation, Bureau of Transportation Statistics

WISCONSIN



A top 10 list to regret

There is a lot to envy about California, but its fiscal budget wreck is not one of them. Unfortunately, a November report by Pew Center on the States included Wisconsin as one of the 10 states that are emulating the worst traits of the Golden State.

The Pew report used California's fiscal troubles as a template and analyzed all 50 states for those that might be moving down a similar path. It ranked Wisconsin in a tie with Illinois for ninth worst. The state is facing a serious structural budget shortfall, compounded by heavy job losses that will significantly affect tax collections going forward. The report also noted a fiscal decision-making pattern whereby budget deficits were patched by one-time maneuvers rather than fixed on a structural basis, along with the creation of significant new programs and spending in the face of deep deficits.

Not surprisingly, state officials quarreled with the Pew report, pointing out that certain benchmarks—like foreclosures, change in unemployment and size of the budget gap—were in line with national averages and far better than California's rates on these measures.

Putting a lasso around carbon emissions

A Wisconsin utility has reportedly accomplished the difficult task of preventing carbon dioxide emissions from escaping into the atmosphere.

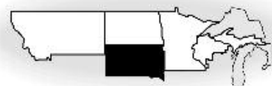
In an experiment at one of its coal-fired power plants, We Energies used chilled-ammonia technology that was first developed by the French firm Alstom. The process acts as a magnet for carbon dioxide and purifies it for possible sequestration underground, rather than being released into the air.

The experiment managed to capture 90 percent of the carbon dioxide emissions from a small, designated portion of total emissions. Results were released after a year-long, continuous test that began in September 2008.

The $8 million experiment was sponsored by 37 firms and the Electric Power Research Institute. Despite the success, many obstacles remain before the technology becomes viable. For starters, there are no appropriate geological formations that would be able to retain the carbon dioxide, which means any captured CO_2 would have to be piped elsewhere—one reason why the carbon dioxide captured by the test was eventually released back into the air.

—Ronald A. Wirtz

SOUTH DAKOTA



Cash for guzzlers

Maybe South Dakota never got the memo.

The federal "cash for clunkers" program offered up to $4,500 to drivers to upgrade their vehicles to more fuel-efficient models. But according to an investigation by the *Argus Leader*, state residents there used the program as an opportunity to simply trade in their vehicle for a discounted new one, with little net gain in fuel efficiency.

The program's two best sellers in the state were the Ford F-150 and Chevy Silverado, both of which get about 16 miles to the gallon. For 90 percent of these purchases, the average trade-in improved net gas mileage by about three miles per gallon, the newspaper found. Average gas mileage for all new vehicles sold nationwide was 24.9, compared with 23.5 in South Dakota—a 6 percent difference—mostly the result of higher truck sales.

In all, the cash for clunkers program in South Dakota snagged $10.3 million in federal incentives for about 2,500 trade-ins, according to federal databases, or about $4,200 per vehicle.

The sound of hammer silence

Despite the fact that the state unemployment rate, at about 5 percent, is low compared to most states, the construction sector in the state has been taking its lumps during the recession.

Associated General Contractors of America, an industry trade group, said total employment in the sector dropped by about 1,400, or about 6 percent, during the 12 months ending this past September. If accurate, that would represent more than one-fifth of the net drop in employment statewide during this period, according to state figures. Sioux Falls saw the single largest drop of any city, from about 8,500 to 8,000 construction jobs.

The good news for the state and its largest metro is that it fared much better than most. The loss rate of construction jobs in Sioux Falls, for example, was lower than in 80 percent of metros nationwide.

There also might be work around the corner for some hammers. According to a November report by Moody's, South Dakota was one of 11 states (which also included Montana and North Dakota) emerging from the recession, based on employment rates, home prices, residential construction and manufacturing.

—*Ronald A. Wirtz*

Looks like another slow year

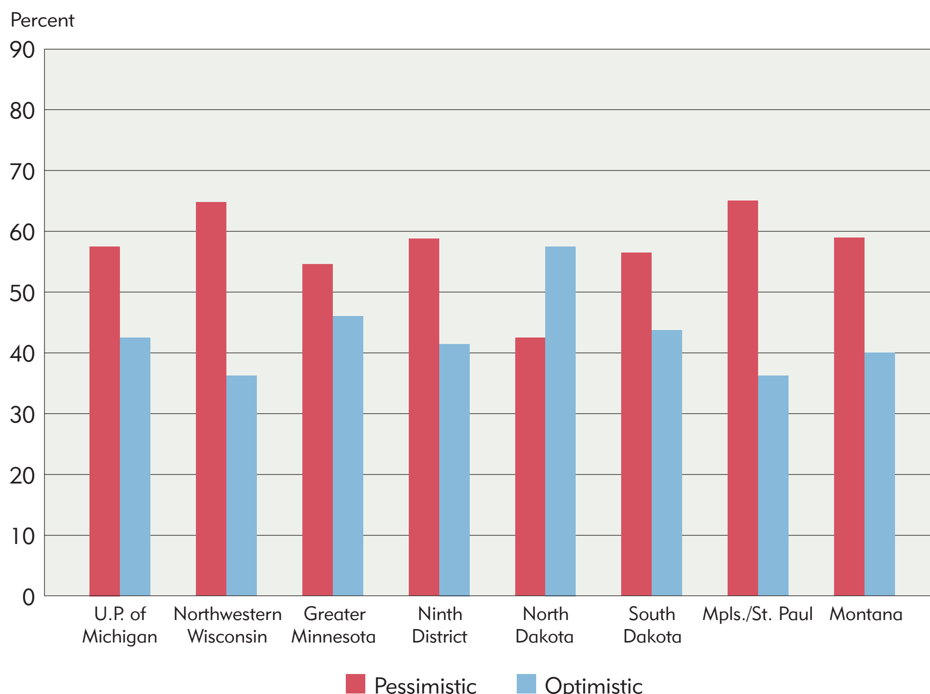
By TOBIAS MADDEN
Regional Economist

Business leaders predict very sluggish growth in the U.S. economy in 2010, according to the November *fedgazette* business outlook poll. This was evident across district states as well as across economic sectors. Leaders remain pessimistic for their own businesses and communities. Tight credit conditions are still a concern for about a third of the respondents. The overall economic outlook is somewhat better than a year ago, and modest inflation is expected.

Respondents across the Ninth District believed their local economies would contract in 2010. Sentiment regarding business investment, employment, consumer spending and housing starts all remains pessimistic. Respondents see a rebound in sales revenues and anticipate flat prices for their products. However, they anticipate slight cuts in employees and capital investment. Leaders are not very concerned about finding good people, but are very concerned with government regulation.

CHART 1

Overall, what is your outlook for your community's economy in the next 12 months?



Source: Federal Reserve Bank of Minneapolis business outlook poll

Sluggish national growth

"There is going to be very slow growth," commented a Minnesota manufacturer. About two-thirds of the respondents expect growth in U.S. GDP of 1 percent to 2 percent, and one quarter expect a recession in 2010. Responses were consistent across the district, with a slightly higher proportion of U.P. respondents expecting the recession to continue. Meanwhile, more respondents from the agriculture and construction industries expect a continued recession compared with those from the manufacturing industry. "Our general contracting business has no backlog and our real estate company has no clients," said a U.P. construction company respondent.

Respondents believed inflation would be modest in 2010. Concerns about near-term inflation are generally muted: Nearly a quarter of respondents predicted inflation of only around 1 percent, and 42 percent about 2 percent; however, 19 percent predicted inflation of 4 percent or higher, the highest percentage of which come from Montana and northwestern Wisconsin. Several leaders indicated that they are very concerned about higher inflation hitting in a few years. "Expect CPI to have a slow change over the next 12 months, but faster than average in inflation in 24 to 36 months," a Montana respondent said.

Pessimism

Almost 60 percent of respondents are pessimistic about their community's economic performance in 2010 (see Chart 1). The pessimism is strongest in the Minneapolis/St. Paul area and northwetern Wisconsin. In contrast, North Dakota respondents were optimistic.

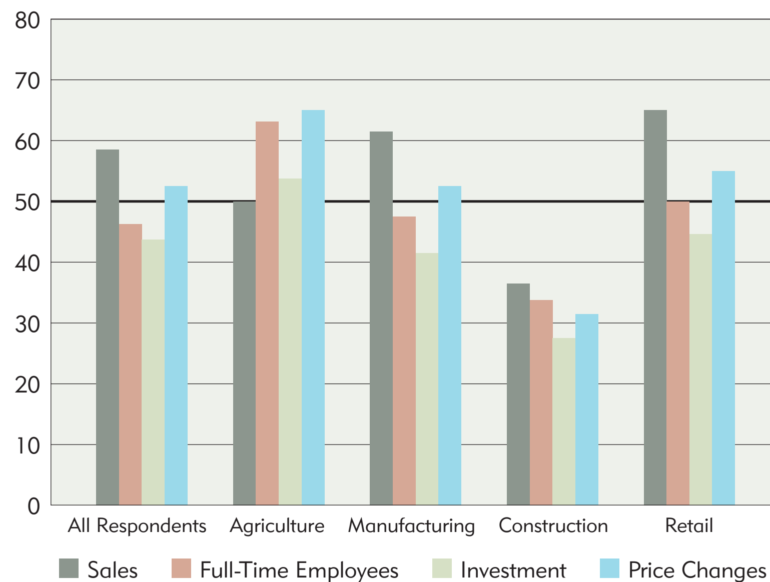
Respondents across the district and economic sectors expect large declines in employment in their community's economy. Anticipated wage increases are very soft, as nearly two-thirds expect 0 percent to 1 percent increases in 2010. No respondents expect wages in their community to rise more than 3 percent. Meanwhile, business investment is expected to fall in 2010. "There is little incentive to invest in any new business expansion with prospects for higher taxes, more regulation and depressed demand for services," a Minnesota respondent said.

The decrease in employment and capital investment may be affected by the consumer spending outlook. Nearly half of the respondents believe consumers will spend less in their communities. The results are similar for respondents across states and sectors.

Nearly half of respondents also predict that housing starts will decline further in 2010. "There is no sign of recovery in housing," commented a Minnesota manufacturer that supports the housing industry. Respondents from all district states and economic sectors expect an overall decline in housing starts in 2010.

CHART 2

With regard to your own company, how do you see operations changing during the next year?
(Above 50 indicates expansion; below 50 indicates contraction)



Source: Federal Reserve Bank of Minneapolis business outlook poll

Higher sales but less employment and investment

Sales revenue in 2010 is expected to increase from 2009 levels across the district except in Montana, where a sales decrease is anticipated (see Chart 2 on page 14). Meanwhile, sales gains are expected across all sectors except construction. "Forest products have been terrible for three and a half years with another year, at least, to go," commented a Montana manufacturer that supports the construction industry.

Meanwhile, employment is projected to fall further. A quarter of the respondents expect to decrease employment in 2010, while 18 percent expect to increase jobs. Every sector and geographic area foresees decreased hiring. Most respondents reported that securing workers is not a challenge.

Access to credit may be affecting hiring and capital expenditure decisions. About a third of the respondents reported that access to bank credit has deteriorated over the past three months. As a result, 21 percent of respondents say it affected their hiring plans. "Businesses are struggling and, as they weaken, credit just gets tougher," commented a Minnesota manufacturer. Another Minnesota manufacturer noted that "banks are pulling back on credit—they need to continue lending or small businesses like us will struggle and fail." Tighter credit may be affecting capital expenditures, as nearly a third said the difficulty accessing credit has hurt planned capital expenditures. "They have added new restrictive reporting requirements and are not funding projects they would have funded in the past," said a Minnesota agricultural producer.

Investment in plant and equipment is expected to drop in 2010, with a third of respondents expecting decreased levels and 21 percent anticipating increased levels. The decrease is widespread across sectors and geography. Productivity was sluggish in 2009: 44 percent of respondents reported level or decreased productivity.

Company pricing pressure is modest. A quarter of respondents expect to increase prices on their products and services, while 20 percent see price declines in 2010. Moderate price pressure is stable across district states but varies among sectors. Only 5 percent of construction firms expect to increase prices, while 40 percent expect to decrease prices. Meanwhile, 57 percent of agricultural producers expect higher prices for their products.

The biggest challenge facing businesses is complying with government regulation. Eighty-six percent of respondents reported that complying with government regulations will be a challenge in 2010. Said one Minnesota construction company, "Government regulation continues to add cost with little benefit realized." f

Manufacturing crashed in 2009; small bounce expected in 2010

By TOBIAS MADDEN
Regional Economist

Manufacturing activity declined significantly in 2009 across the Ninth District. Manufacturers' outlook for their operations in 2010 is for a small bounce back, but they expect the overall economy to fall further, according to the November survey of manufacturers conducted by the Federal Reserve Bank of Minneapolis and the Minnesota Department of Employment and Economic Development.

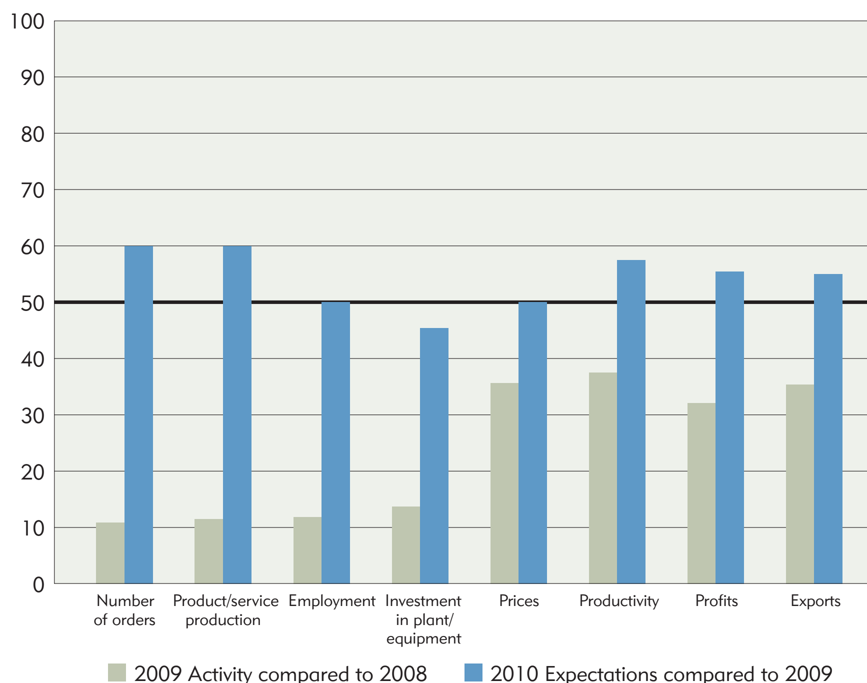
Manufacturers were blown away in 2009. "The economy is terrible," noted a small Minnesota manufacturer. A whopping 72 percent of respondents said orders were down in 2009 from 2008. Two-thirds sliced production, and 61 percent cut employment. Manufacturers also cut investment and product prices. Profits fell as well. "I've been in business for 33 years and now face losing it," said another small Minnesota manufacturer. The dismal results were evident across states and sizes of firms. "We are struggling to survive and may not make it," a small South Dakota producer said.

Many manufacturers are experiencing tighter credit: 28 percent reported that their access to bank credit deteriorated over the past three months, and only 9 percent said credit conditions improved. "We were dropped by our bank of 10 years even though we were never late on any payment. Our sales and profits are down, and we no longer 'fit' their risk tolerance, which they blame on tighter scrutiny by the Federal Reserve," said a medium-sized Wisconsin firm.

Compared with 2009, manufacturers' outlook for orders and production are up (see chart). However, they expect to keep employment, investment and prices at 2009 levels. "We are keeping the door open and waiting for an upturn in the economy," a Montana medium-sized producer said. Manufacturers expect productivity and profits to edge up in 2010 from 2009 levels. Meanwhile, after dropping in 2009, respondents believed exports will increase slightly in 2010, led by Minnesota and South Dakota exporters.

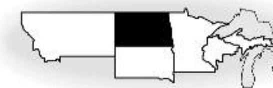
Even though respondents expect their own businesses to recover somewhat, they anticipate continued deterioration in their state economies. "Hold on to your hat; this is gonna be a tough one coming!" said a small Montana manufacturer. Respondents anticipate downturns in business investment, employment, corporate profits and consumer spending, and they believe overall economic growth will be flat. Respondents from the Dakotas are the most optimistic, and those from the Upper Peninsula of Michigan are the most pessimistic for their state economies. Over half of respondents expect increased inflation levels in 2010 from the tepid inflation of 2009. f

Manufacturing activity was way down in 2009 and should increase slightly in 2010
(Above 50 indicates expansion; below 50 indicates contraction)



Sources: Federal Reserve Bank of Minneapolis; Minnesota Department of Employment and Economic Development

NORTH DAKOTA



Harvests good, but don't hold your breath

Things came up mostly green for North Dakota's farmers this year.

According to the U.S. Department of Agriculture, the state's soybean crop will be up 10 percent from a year ago, thanks to higher yields and an increase in harvested acres. The state is also a leader in pulse crops, which had banner years. The state's dry pea crop rose 46 percent, and the lentil harvest is expected to be more than triple the size of last year's crop because of significantly more harvested acres, which itself was driven by prices that are double those in 2006. The state's average sunflower yield is expected to approach its 2005 record.

Not everyone is having a spectacular year, however. Potato growers are facing blight for the first time in years and expect production to drop by 17 percent. The corn crop is down by one quarter, though mostly due to much lower harvested acres. The wheat harvest is only expected to match its five-year average.

State farmers also have been pioneers in getting paid for their carbon-capturing ability, but prices for so-called carbon offsets have crashed. In May 2008, carbon contracts were trading over $7 per metric ton on the Chicago Climate Exchange. Prices dropped to about 60 cents by summer and to 15 cents in early December.

Exporting the wind

The burgeoning wind market in North Dakota is starting to find sales outlets in other states.

Recently, the Tennessee Valley Authority, which serves a seven-state region, agreed to purchase 200 megawatts of power annually from a wind farm being developed in Ashley, N.D., along with 250 megawatts from a wind farm in neighboring South Dakota.

The Western Area Power Administration has also signed a three-year deal to buy up to 50 megawatts annually from a wind farm owned by Basin Electric Power Cooperative. WAPA is a federal agency serving a 15-state region that markets hydroelectric power generated from rivers in 11 states. The agency is attempting to integrate water and wind power, and is also negotiating for 100 megawatts of wind power from an independent wind farm developer with holdings in both North Dakota and Minnesota.

—Ronald A. Wirtz

fedgazette

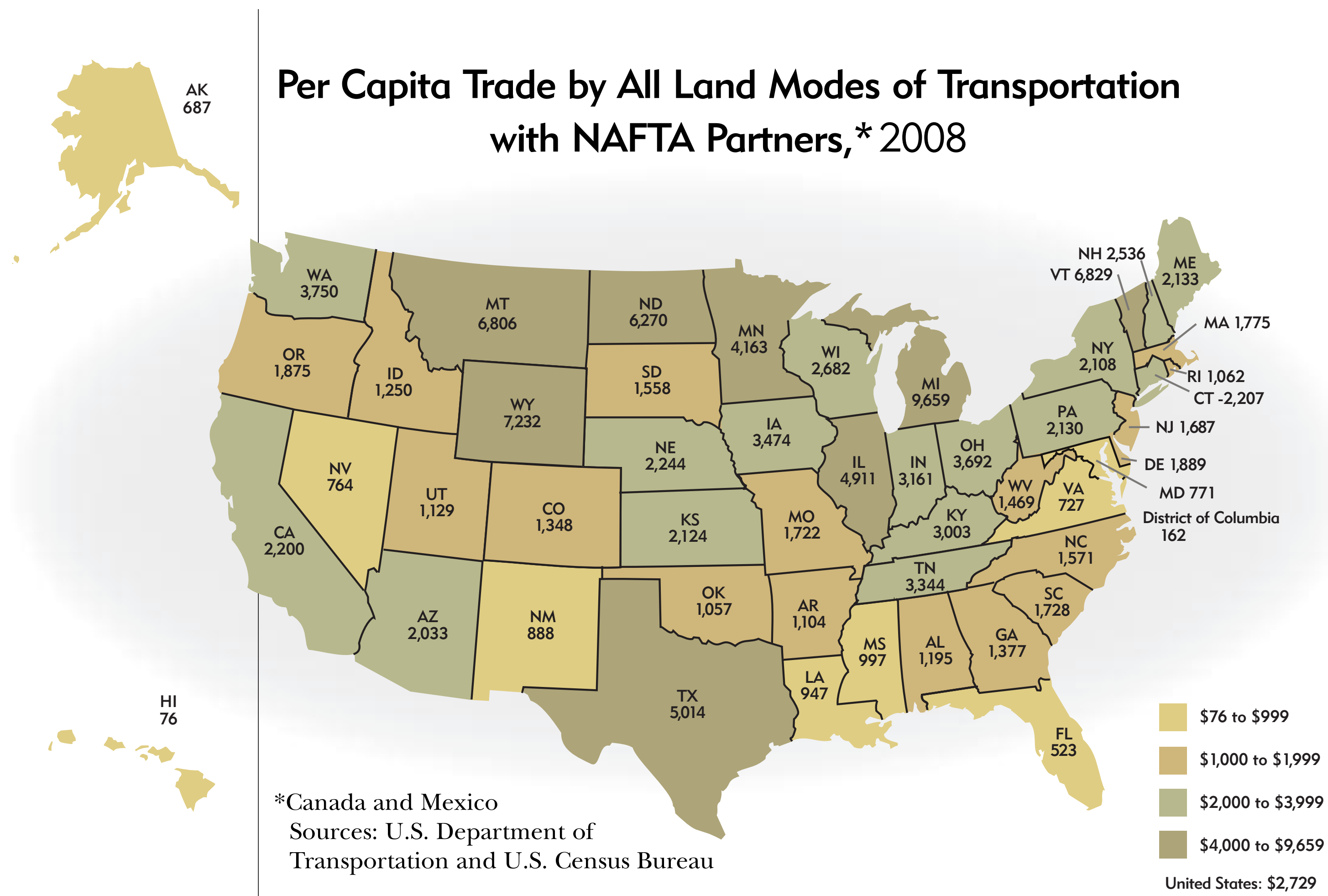
Public Affairs
Federal Reserve Bank of Minneapolis
90 Hennepin Avenue
P.O. Box 291
Minneapolis, Minnesota 55480-0291

Change Service Requested

Presorted
Standard
U.S. Postage
Paid
Permit No. 2235
Minneapolis, MN

January 2010

Per Capita Trade by All Land Modes of Transportation with NAFTA Partners,* 2008



*Canada and Mexico
Sources: U.S. Department of Transportation and U.S. Census Bureau