A slow recovery is under way

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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.

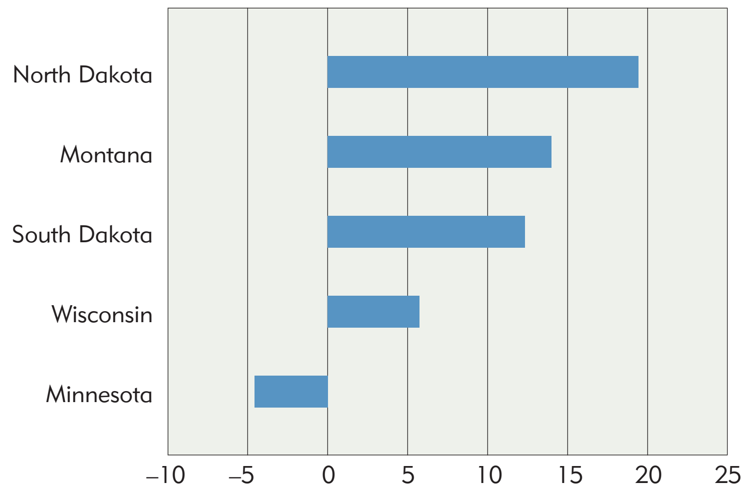
However, as personal income slipped in 2009, consumers did not have to face price increases at the checkout line; in fact, they were more used to encountering price decreases in 2009. The consumer price index was down 0.6 percent for the first 11 months of 2009 compared with a year earlier, which means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

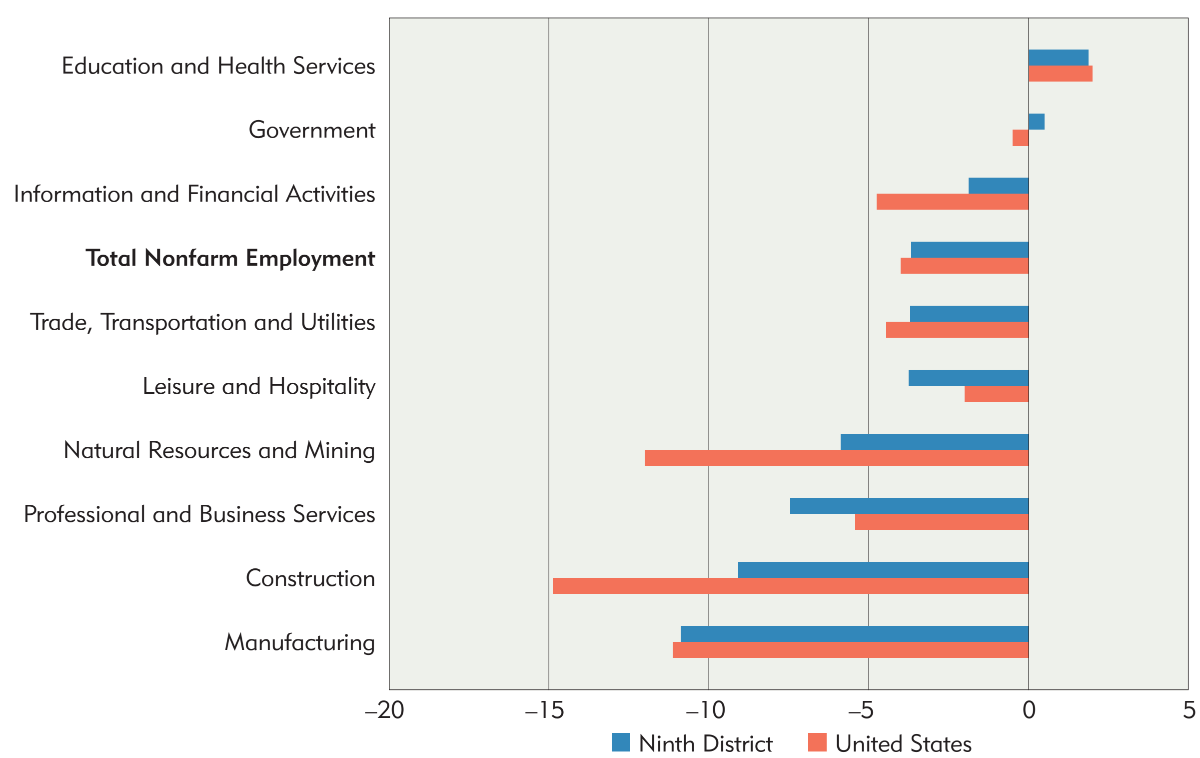
Percent change in existing home sales from a year earlier, third quarter 2009



Source: National Association of Realtors

CHART 2 **Employment decreased in almost all industries**

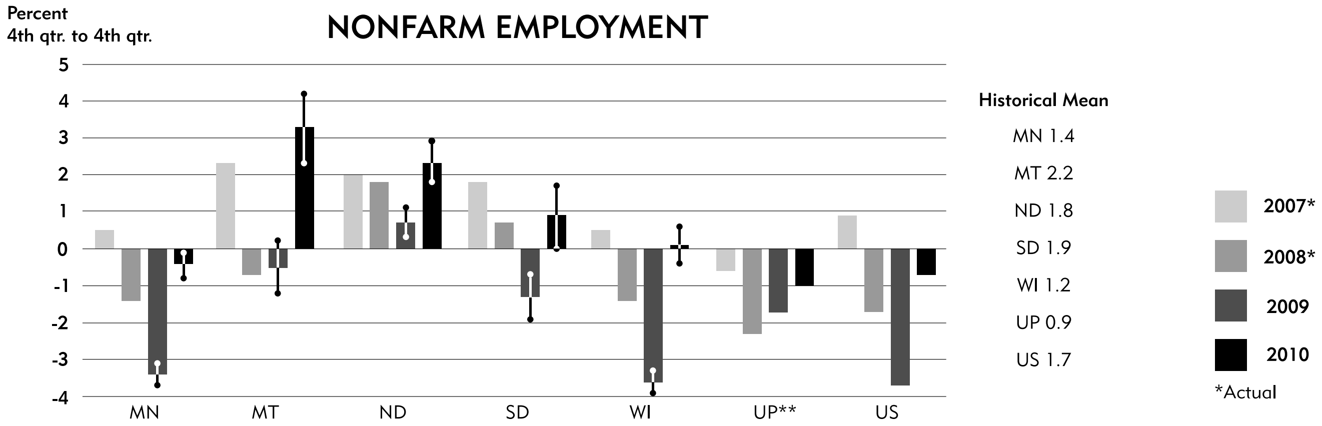
Nonfarm employment, percent change from a year earlier, October 2009



Source: Bureau of Labor Statistics

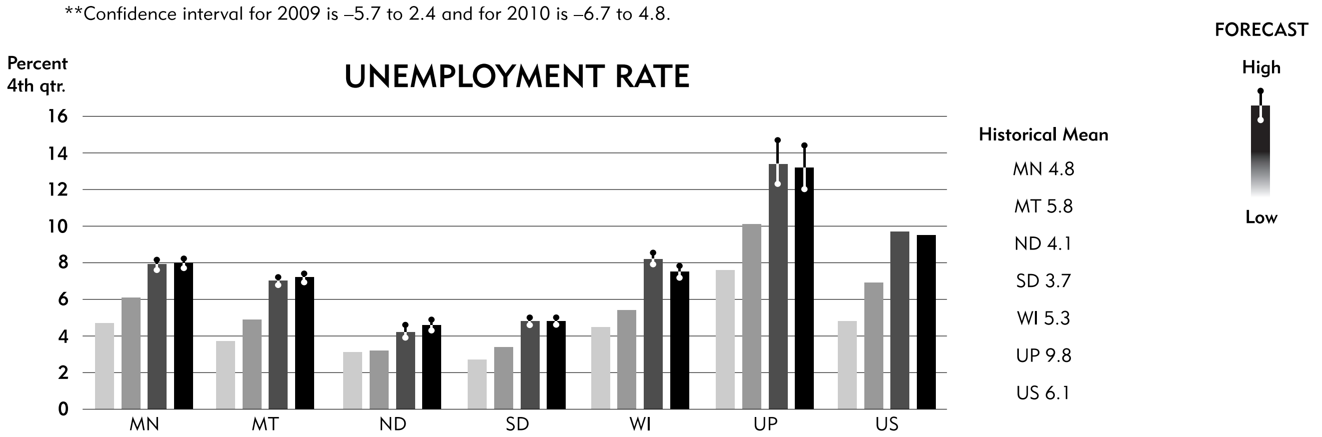
District Forecast

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.

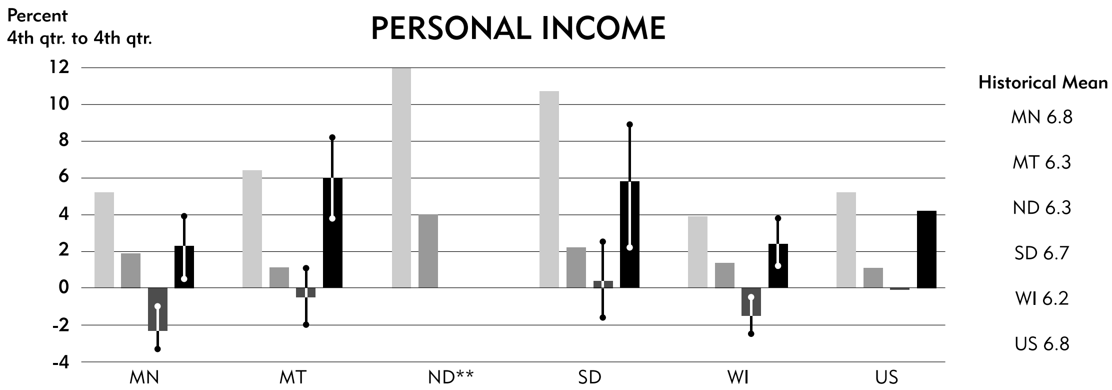


**Confidence interval for 2009 is –5.7 to 2.4 and for 2010 is –6.7 to 4.8.

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.

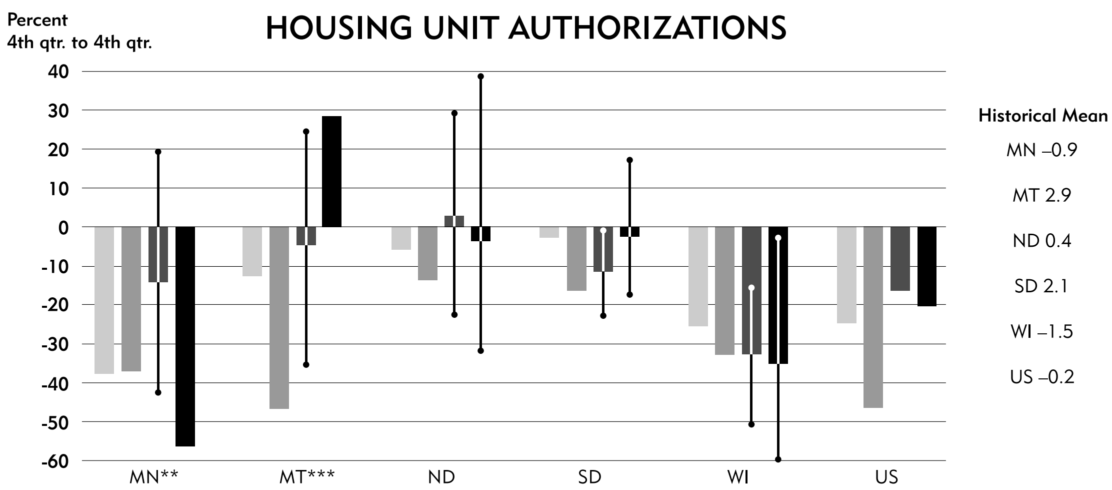


Personal income is expected to rebound moderately. During 2009, personal income decreased throughout the district except in South Dakota, where personal income increased slightly. In 2010, personal income is expected to grow in all areas except North Dakota. The predicted increases are close to historical 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.

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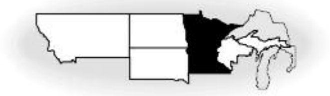
MINNESOTA



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. f