A soft district economy expected

By ROB GRUNEWALD
Associate Economist

TOBIAS MADDEN
Regional Economist

The slow housing sector, tighter credit conditions, and higher energy and food prices have contributed to a soft district economy. According to the Minneapolis Fed's forecasting models, soft economic growth will continue into 2009. On a positive note, growth in manufacturing and natural-resource-based sectors and increases in personal income could keep the economy from slowing further.

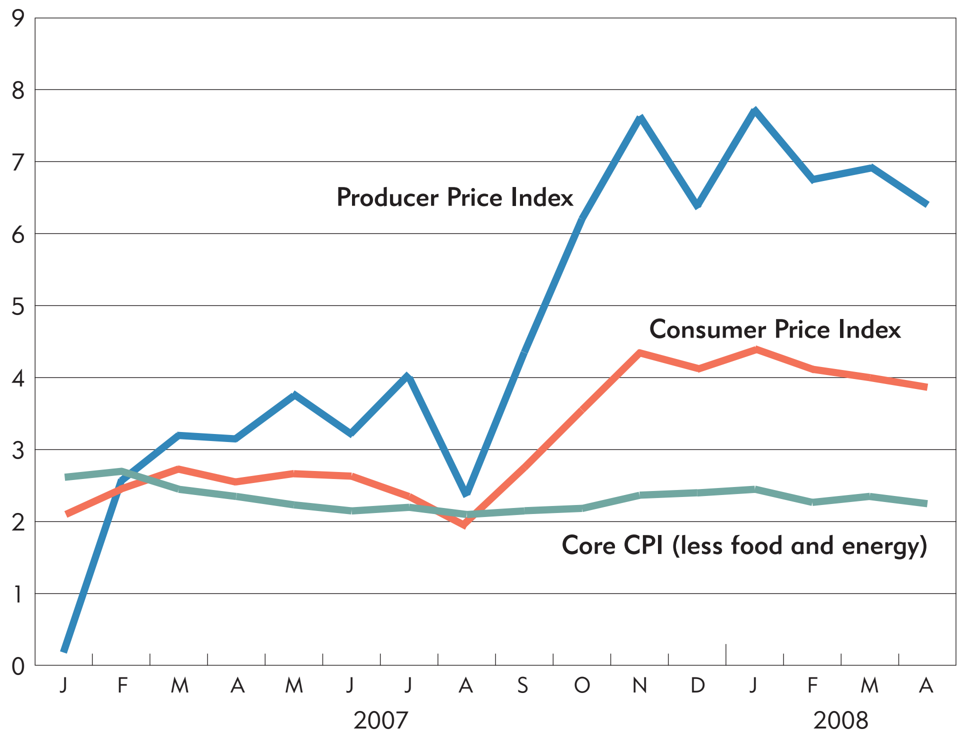
Housing continues to hamper economic growth

During the recession of 2001, relative strength in residential investment helped keep the economic contraction relatively mild. In contrast, since the second quarter of 2006, the downturn in residential investment has shaved about 1 percent off the annual rate of U.S. gross domestic product growth each quarter through the first quarter of 2008. While the U.S. economy hasn't dipped into a recession, the housing slump accounts for a good share of the recent slowdown.

At the district level, housing units authorized decreased in all states during 2006 and 2007, with particularly large decreases in Minnesota and Wisconsin (see page 22). Furthermore, languid housing markets have led to declines in home sales and prices. Decreases in sales of existing homes from the first quarter of 2007 to the first quarter of 2008 ranged from –2 percent in South Dakota to –24 percent in Wisconsin. The average home price decreased 10 percent in Minneapolis-St. Paul and 3 percent in Sioux Falls, S.D. The Minneapolis Fed's forecasting models suggest that housing units authorized will begin a recovery in some states during 2008 and 2009. (For a broader discussion of housing trends in the Ninth District since 1999, see article on page 19.)

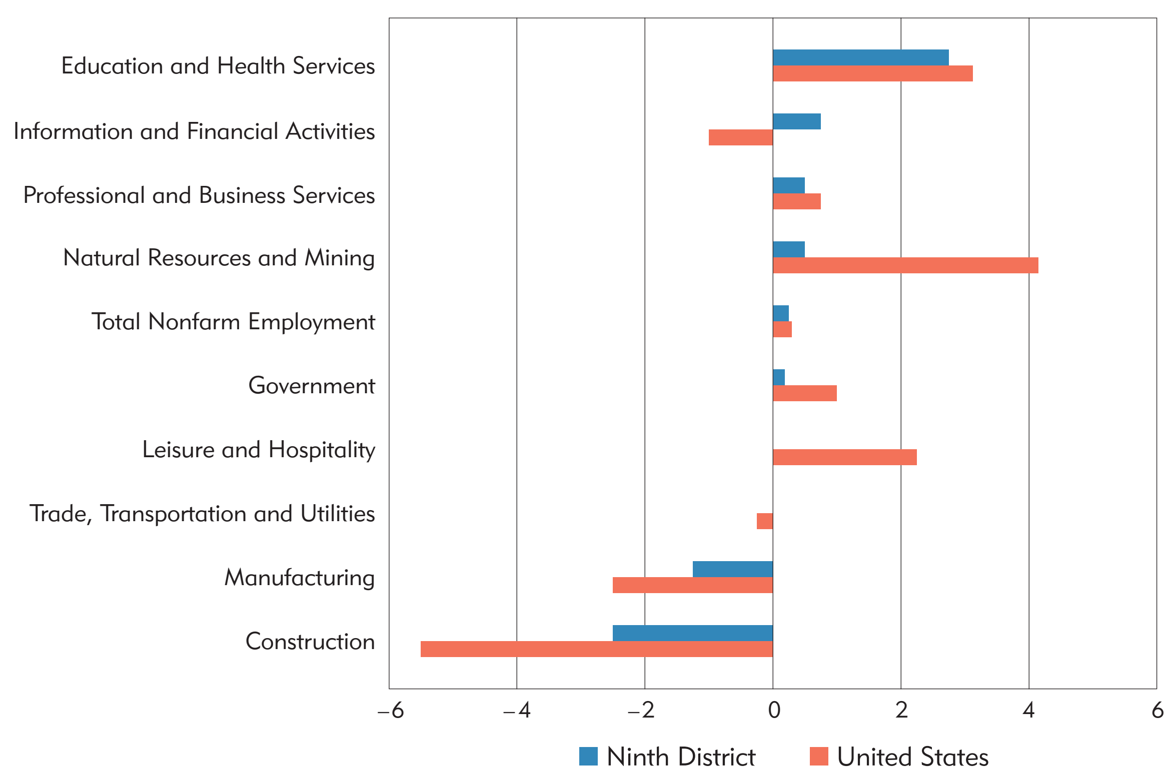
Continued on page 22

Producer and Consumer Prices
Percent change from a year earlier



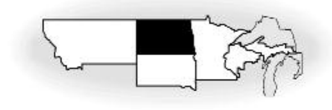
Source: Bureau of Labor Statistics

Nonfarm Employment, Ninth District vs. U.S., April 2008
Percent Change From a Year Earlier



Source: Bureau of Labor Statistics

NORTH DAKOTA



The New Orleans of the Great Plains

While lakes and rivers in other parts of North Dakota are shrinking from dry conditions, Devils Lake keeps rising higher and higher, and that continues to have significant financial consequences for government at all levels.

Devils Lake has been on the rise since 1993, when it entered what geologists call a wet cycle, or above-average precipitation. The problem is that it is a terminal lake, meaning that is has no natural outlets. The lake level rises as it absorbs more water as the region's catch basin. Over the past decade and a half, the lake has risen 25 feet, ballooning it to an estimated 140,000 acres.

But a U.S. Geological Survey representative testified at a Senate subcommittee meeting in March that the lake stood about a 70 percent chance of continuing to rise over the coming decade and a 30 percent chance of rising for the next three decades.

Local, state and federal governments have reportedly spent more than $500 million to repair and raise roads, relocate homes and other infrastructure and protect the city of Devils Lake, which is roughly 90 miles west of Grand Forks. About half that amount has been spent on levees, other infrastructure and emergency protection measures for the city, according to an official from the state's Water Commission.

More spending will be necessary if the lake rises. A federal highway official estimated that further relocation of roads would cost about $280 million, according to local news reports. The mayor of Devils Lake estimated that future levee work might cost $100 million.

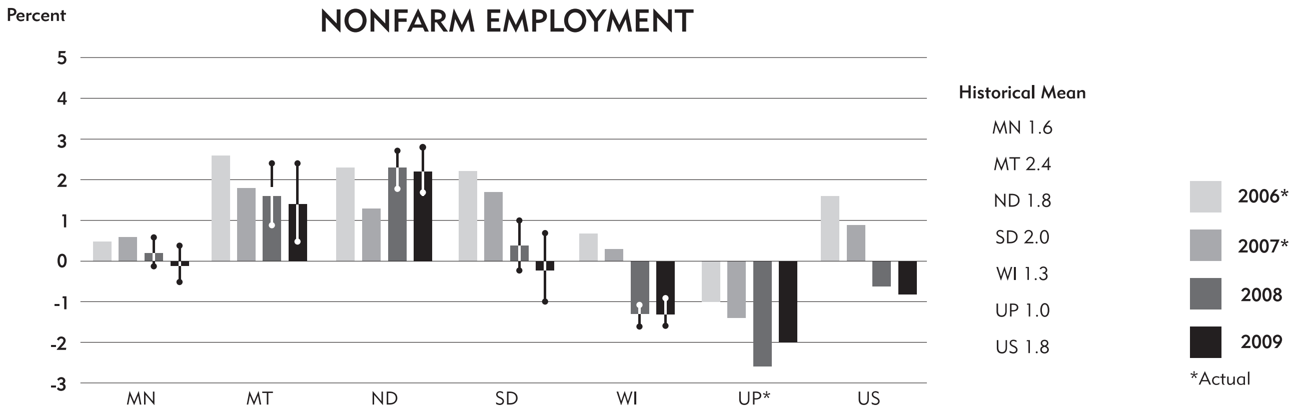
This spring, the Army Corps of Engineers announced it would spend $5 million on a study to look at flood-protection options for the lake's entire basin. U.S. Sen. Kent Conrad also entered the fray when he announced that the newest farm bill, passed in May, included provisions that allow affected landowners to sign up for the wetlands portion of the Conservation Reserve Program.

The state is also looking to renew a permit that allows it to operate an artificial outlet into the Stump River. Constructed in 2005 at a cost of $28 million, it has operated sporadically since then because lake levels have fallen slightly, and the outlet cannot be operated when certain environmental conditions exist, like high sulfate levels.

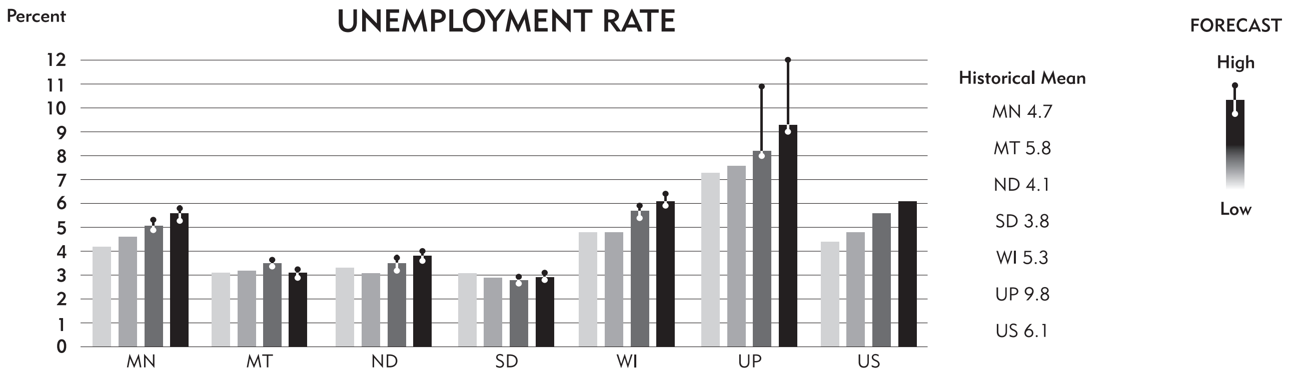
—*Ronald A. Wirtz*

District Forecast

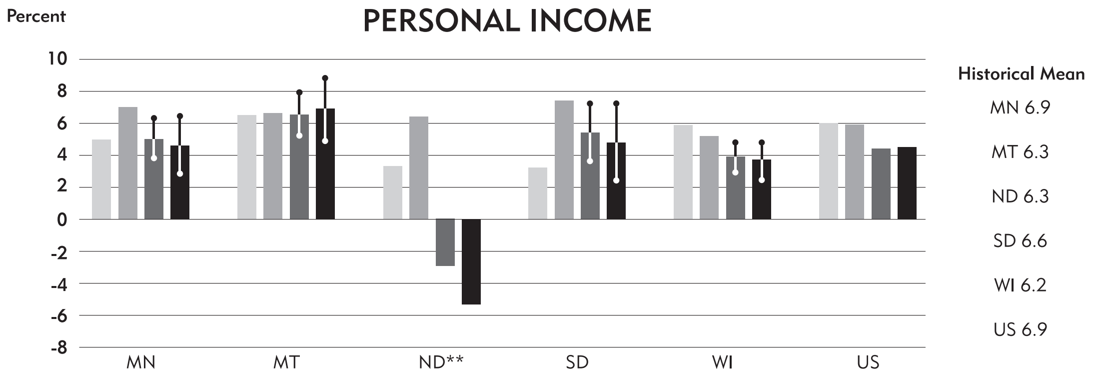
Nonfarm employment growth will stagnate. Employment will grow at a slower rate in 2008 than in 2007 in Minnesota, Montana and South Dakota and at a faster rate in North Dakota. Meanwhile, employment will decrease in Wisconsin and the Upper Peninsula of Michigan. In 2009, nonfarm employment will increase in Montana and North Dakota, but at slower rates than in 2008. Employment will decrease slightly in Minnesota and South Dakota and decrease more than 1 percent in Wisconsin and the Upper Peninsula. Nonfarm employment growth will remain below historical averages in all states except North Dakota, where growth rates will exceed historical averages in both 2008 and 2009.



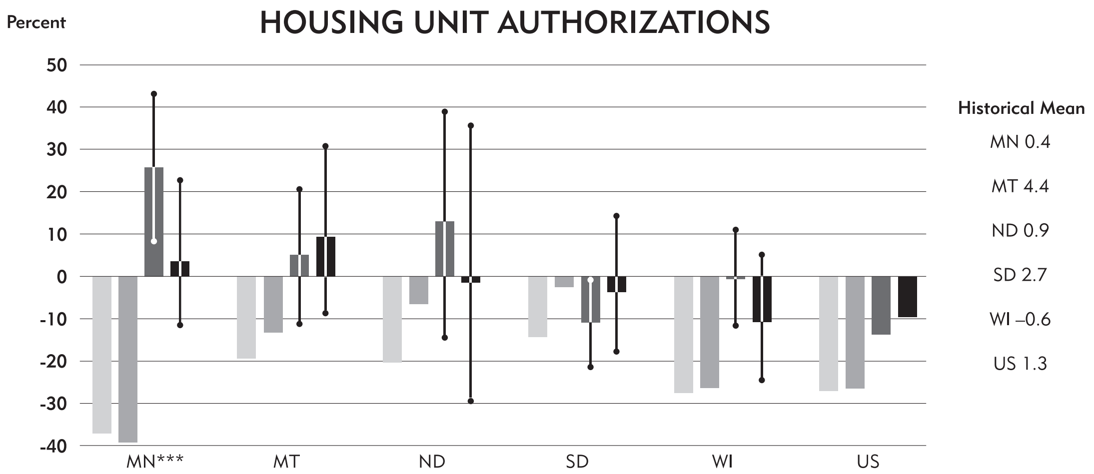
Unemployment rates will increase, finishing higher in 2008 than in 2007 in all areas except South Dakota, where rates will decrease slightly. Nevertheless, unemployment rates will remain below historical averages, except in Minnesota and Wisconsin, where rates will climb above their historical averages. In 2009, unemployment rates will increase above 2008 levels, except in Montana, where rates will decrease. Other than in Minnesota and Wisconsin, rates in 2009 will remain below historical averages.



Personal income will grow. Personal income will continue to grow in 2008, but at slower rates than in 2007, in all states except North Dakota, where income will decrease. In 2009, income growth will slow from 2008 rates in all states except Montana, where income growth will increase, and North Dakota, where income levels will decline. The predicted decrease in North Dakota possibly reflects changes in farm income, which tend to be volatile.



Housing units authorized will begin a recovery in some states following substantial decreases across all states in 2006 and 2007. Authorizations will increase in fourth quarter 2008 compared with a year earlier in Minnesota, Montana and North Dakota, while home building will decrease in South Dakota and Wisconsin. The relatively large increase predicted for Minnesota (26 percent) comes after authorizations plummeted to their lowest level since the forecasting model has been recording data (1976) in fourth quarter 2007. While Minnesota home building is likely digging itself out of a major slump during 2008, for the year as a whole (all four quarters), authorizations will be lower in 2008 compared with 2007 not only in Minnesota, but in all district states. In 2009, housing units authorized will increase in Minnesota and Montana, but decrease in North Dakota, South Dakota and Wisconsin.



*Confidence interval for 2008 is –6.4 to 1.8 and for 2009 is –8.0 to 4.3.
**Confidence interval for 2008 is –15.5 to 13.2 and for 2009 is –23.1 to 16.3.
***Large predicted increase in fourth quarter 2008 follows record low in fourth quarter 2007. See adjacent paragraph.

Outlook from page 21

Recent strains in financial markets are attributed in part to weakness in the housing sector. Home foreclosures have increased, and mortgage and consumer credit requirements have tightened. Large commercial banks have written off billions of dollars of mortgage loans.

Credit standards for many types of loans have tightened, a potential constraint on consumer spending. Furthermore, cash-out refinancing levels have decreased as assessed home values have declined. During the first quarter of 2008, the value of home equity cashed out through refinancing of loans owned by Freddie Mac was about one-third the amount during the first quarter of 2007.

Despite tightening in credit standards, the amount of consumer credit outstanding increased 5.4 percent at an annual rate in the first quarter of 2008, only slightly lower than the 5.7 percent increase for 2007. Personal income has also continued to climb, a good sign for consumer spending, although growth slowed during the first quarter of 2008. Consumer spending grew 1 percent during the first quarter, compared with 2.3 percent growth during the fourth quarter of 2007. This result mirrors a recent informal survey of district retailers that suggests continued modest growth in consumer spending. However, adjusted for inflation, consumer spending has fallen.

Energy and food prices increase

Consumers are facing higher energy and food prices, but the core rate of inflation remains relatively tame. The Consumer Price Index in April 2008 was 3.9 percent higher than in April 2007. Once prices for energy and food are removed, the core CPI in April was 2.3 percent higher than a year ago. Nevertheless, energy and food represent about 20 percent of total personal consumption expenditures, and higher prices mean less spending on other goods and services, particularly for lower-income households.

Continued on page 23

Consumers are not the only ones facing higher costs—so are producers. The Producer Price Index, which measures inflation at the wholesale level, increased 6.4 percent in April compared with a year ago.

Employment flat; manufacturing aided by exports

Labor markets have slackened, with virtually no growth and higher unemployment rates. District nonfarm employment grew 0.2 percent in April compared with a year ago. Education and health services showed the strongest gain in employment (2.7 percent), followed by information and financial services (0.8 percent). Meanwhile, employment levels in manufacturing decreased 1.2 percent and construction employment dropped 2.4 percent. The Minneapolis Fed's forecasting models point to stagnant employment growth and higher unemployment rates into 2008 and 2009.

Despite the decrease in employment levels, output in the manufacturing sector has increased in Minnesota and the Dakotas, according to a May survey of purchasing managers by Creighton University (Omaha, Neb.). Manufacturing output has been buoyed by steady growth in exports as the world economy has grown faster than the U.S. economy and the exchange rate of the dollar relative to other currencies has made U.S. goods less expensive abroad. During the first quarter of 2008, growth in manufactured exports from district states ranged from 8 percent in Minnesota to 44 percent in North Dakota.

In addition to a healthy manufacturing sector, the mining and oil drilling sectors in the western part of the district remain active in the context of strong metal and energy prices.

Farmers get a late start on 2008

Large harvests and high prices boosted farm profits in 2007. However, the first half of 2008 has seen higher input costs and delays in planting. Ranchers are getting squeezed with rising feed costs and stable output prices. Ethanol and biodiesel continue to affect district agriculture. Land prices continue to increase, and many are wondering if prices will peak in 2008. (For a detailed discussion of farmland prices and related ag issues, see the cover article in this issue of the *fedgazette*.)

According to the Minneapolis Fed's first-quarter (April 2008) agricultural credit conditions survey, 2007 was a strong year for agricultural income, with 90 percent of survey respondents reporting increased income. Agricultural lenders are somewhat optimistic for farm profits in the second quarter of 2008, with 61 percent expecting increased income and only 5 percent expecting decreased income.

AVERAGE FARM PRICES

	2005/2006	2006/2007	Estimated 2007/2008	Projected 2008/2009
(Current $ per bushel)				
Corn	2.00	3.04	4.20–4.45	5.30–6.30
Soybeans	5.66	6.43	10.00	11.00–12.50
Wheat	3.42	4.26	6.50	6.75–8.25

	2006	2007	Estimated 2008	Projected 2009
(Current $ per cwt)				
All Milk	12.90	19.13	18.90–19.30	18.15–19.15
Choice Steers	85.91	91.82	89.00–93.00	89.00–97.00
Barrows & Gilts	47.26	47.09	46.00–48.00	47.00–51.00

Source: U.S. Department of Agriculture, estimates as of June 2008

Farmers are concerned about the start of 2008. Due to foul weather in many parts of the district, planting was delayed and corn and soybean crop progress is slow. This may negatively affect yields at harvest time. The western Dakotas and eastern Montana are in a severe drought, although the heavy mountain snowpack bodes well for reservoirs and irrigation. So far the wheat crop appears in good condition.

For farmers, the outlook for prices is strong. Corn, soybean and wheat prices are all expected to increase from 2007 into 2008 and further increase into 2009. The outlook for revenues is mixed, as higher prices may be somewhat offset by lower yields. Profits may not be as large as in 2007 due to increased input costs, including fuel and fertilizer.

For animal producers, the outlook is not as bright. Profits are squeezed by higher costs and flat selling prices. The increased demand by bioenergy producers has put upward pressure on crop prices. This has driven feed costs up for those cattle ranchers who are not near an ethanol plant. In addition to feed, fuel and other costs have also increased. Cattle, hog and milk prices are expected to stabilize in 2008 from 2007 levels and increase slightly in 2009. f

Professional services firms expect sluggish activity over the next year

By TOBIAS MADDEN
Regional Economist

Profits fell slightly over the past year at firms that support businesses, such as accountants, architects, engineers and market researchers, according to results of the annual survey of professional services firms, conducted in May and early June of 2008 by the Federal Reserve Bank of Minneapolis and the Minnesota Department of Employment and Economic Development.

The survey shows that selling prices and productivity increased, but input costs increased faster, which reduced profits. Employment, office space usage and exports were relatively unchanged over the past 12 months. Responding firms expect flat activity at their businesses over the next four quarters. Input costs are expected to shoot up more than sales prices. Firms do not plan to add employees or office space. They expect the overall economy to perform poorly over the next 12 months.

Revenues increased slightly on average over the past year, with 47 percent of respondents reporting higher revenue and 34 percent reporting lower revenue. Much of this revenue increase may be due to higher selling prices for products, since 38 percent of respondents indicated increasing prices and 12 percent indicated decreasing prices. Productivity rose at 36 percent of the respondent firms and decreased at 15 percent. Input costs rose at 72 percent of responding firms, and only 2 percent reported decreasing costs. Average wages increased 3 percent, while benefits grew 2.6 percent. Overall, this resulted in slight decreases in profits. Meanwhile, employment and space usage were flat.

A special question this year asked how tighter credit conditions are affecting businesses. The responses indicate that the credit crunch has had a negative impact on professional business firms' revenues, capital expenditure plans and employment.

The outlook for the next four quarters is for level activity. Service firms expect slightly increased sales revenue and continued productivity growth. Employment and office space usage are forecast to remain flat. Higher input costs (for example, rent, supplies, consultants) and selling prices are anticipated, and profits are expected to remain flat. Respondents expect average wage and benefit costs per worker to increase 2.5 percent and 2.2 percent, respectively, over the next 12 months. "Overall, [the] economy will reduce possible expansion of our business," said an architect from North Dakota.

The outlook for the overall economy is downbeat. For the next four quarters, respondents expect lower employment, consumer spending and corporate profits and higher levels of inflation. Thirty-seven percent predict employment to decrease, and 16 percent foresee employment gains; 63 percent of respondents expect consumer spending to decrease, and 11 percent expect it to increase. Half of the firms think corporate profits will decrease, while 16 percent expect corporate profits to increase. Over three-quarters of the responding firms forecast increasing inflation, and only 1 percent anticipate that inflation will moderate. f

Go online to minneapolisfed.org for complete survey results.