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**U.S. Economy  
Opens a Door  
Toward Recovery**

**The Financial Sector  
Seeks Stability**

**Global Outlook Takes a  
Turn Toward Improvement**

# EconSouth

FEDERAL RESERVE BANK OF ATLANTA FOURTH QUARTER 2009



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### U.S. Economy Opens a Door Toward Recovery

The economy spent much of 2009 in the grip of recession, but signs of a turnaround began to emerge during the year. Significant challenges remain on the road to a full economic recovery, however.

### The Financial Sector Seeks Stability

Breaking the grip of the financial crisis required intense intervention by the U.S. government and regulatory agencies. Policy-makers now seek to maintain the progress they have made and return normalcy to credit markets.

### Global Outlook Takes a Turn Toward Improvement

Economies the world over have endured a difficult period, but many show signs of emerging from their slumps. Developing economies appear to be on the leading edge of recovery while developed economies are rebounding more slowly.

### The Southeast in 2010: Region Hopes for Turnaround

Like other parts of the United States, the Southeast was hit hard by the recession. Significant sectors of the economy, such as construction and employment declined, and state and local governments saw their revenues pinched by dropoffs in tax revenues. But signs of recovery have begun to emerge and position the region for a brighter 2010.



# Small Businesses' Challenge



**JOHN ROBERTSON** is a vice president in the Atlanta Fed's research department.

**A**mong the many issues facing the economy, I am especially concerned about the prospects for a small business-led recovery.

Small businesses have traditionally played a very important role in job creation in the United States. However, small business has been disproportionately negatively affected by this recession. During the last two economic expansions, very small firms (those with fewer than 50 employees) contributed about one-third of net job growth. But the depth of this recession has taken a substantial toll on small businesses. Small firms held up reasonably well in the last downturn, accounting for only 9 percent of net job losses between the first quarter of 2001 and the third quarter of 2002. In contrast,

according to the most recent data available, small firms accounted for about 41 percent of net job losses from the end of 2007 through the first quarter of 2009.

Small businesses also depend significantly on the banking sector for financing. For instance, a 2003 Federal Reserve survey examining financial services used by small businesses showed more than 50 percent of these firms had a credit line or bank loan. In addition, about half of small businesses use a personal or business credit card.

## **When banks suffer, so do small businesses**

The recession has caused both the demand and supply of bank loans to decline. For instance, rising unemployment has reduced the pool of creditworthy borrowers. At the same time, households and businesses have trimmed spending and thus have less need to borrow. Banks have also reduced loan supply, reflecting concerns about the economic outlook and their own balance sheet constraints caused in part by rising delinquencies on existing loans.

The Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices for the third quarter of 2009 shows that most banks continue to tighten the terms on which they extend credit for most kinds of loans. Many small businesses have seen their bank credit lines reduced or the terms of their credit significantly tightened.

The fact that small businesses are usually an important source of jobs and are also relatively dependent on bank lending suggests that a shock to the flow

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Editor's note: Throughout this issue, Southeast refers to the six states that, in whole or in part, make up the Sixth Federal Reserve District: Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee.

Photos on inside front cover (banking) and pp. 10, 29, and 30 by Brad Newton; p. 1 by Flip Chalfant

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# U.S. Economy Takes Steps Toward

# RECOVERY

**GROWTH**

**OPTIMISM**

**RECESSION**

The U.S. economy endured an eventful 2009 as policymakers used every tool in their toolbox—and even invented new ones—to combat the financial crisis. Whether the forces affecting the economy are temporary or part of a reshaped landscape remains to be seen.

**T**he recession officially began in December 2007, as employment and industrial production began to fall. However, the downturn was foreshadowed by a sharp decline in the housing market that began more than a year before that, and it was not until early fall 2008 that the recession turned into a large-scale financial crisis. The pace of job loss was one piece of evidence of the crisis; it accelerated from an average of about 137,000 to 495,000 per month in the last four months of 2008.

Likewise, industrial activity, which was declining in the first half of 2008 at a rather modest annualized pace of 3 percent per month, fell by an average 15 percent in the second half of 2008. And real gross domestic product (GDP) growth, which resisted posting a net decline through the first two quarters of 2008, dropped 4 percent during the second half of the year as virtually every major household and business expenditure category plunged.

Along with these troubling developments in the so-called real economy, financial markets for all practical purposes were shutting down. Interbank lending for anything but the shortest of maturities plunged, investors pulled funds from money market accounts, and the commercial paper market that helps companies fund day-to-day operations dried up. Markets for securitized instruments disappeared. And corporate bond issues slowed to a trickle.

Policymakers' responses to the crisis were extraordinary. In addition to dropping the federal funds rate to essentially zero, the Federal Reserve initiated a number of credit policies intended to restore some measure of financial market function. The U.S. Treasury and the Federal Deposit Insurance Corporation introduced or expanded guarantees on a variety of financial assets, and banks received injections of new capital from both public and private sources.

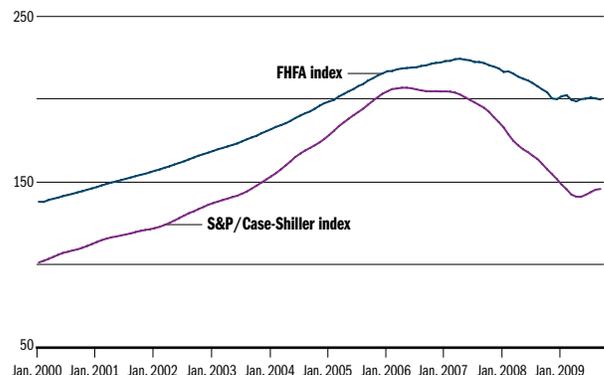
The outlook for 2009 pivoted on a number of unknowns. How soon would the market for residential real estate find a

bottom? What influence would the policy measures have on restoring financial market function and propping up aggregate demand? What other policy actions would be introduced by the incoming administration?

### 2009: Has the recovery begun?

Partial answers to these questions emerged over the course of 2009. New and existing home sales started rising in April, the inventory of unsold homes decreased and home prices, based on a number of measures, leveled off (see chart 1). Industrial activity also picked up in the fall. Even consumer spending, which posted the sharpest downturn for any post-World War II recession, showed signs of improvement. Meanwhile, the pace of job cuts slowed substantially as the year progressed. In the latter

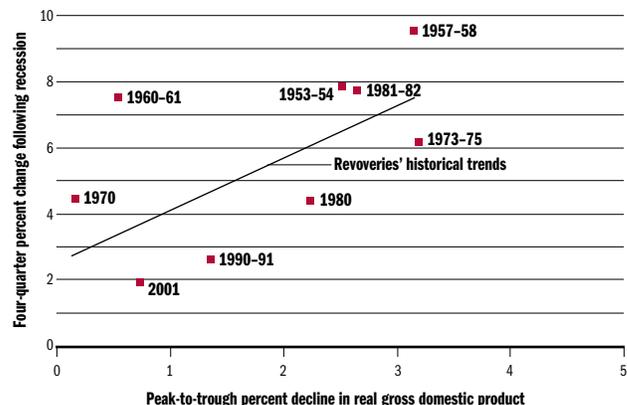
Chart 1  
U.S. Home Price Indexes



Notes: "FHFA" is the U.S. Federal Housing Finance Administration. The S&P/Case-Shiller data are indexed so Jan. 2000 equals 100. FHFA data are purchase only and are indexed so Jan. 1991 equals 100. Data are through August 2009. Sources: Federal Housing Finance Agency, Standard & Poor's, and Fiserv Inc.



Chart 2  
Past Recessions' Severity Versus Recovery



Source: U.S. Bureau of Economic Analysis

part of 2009, the employment decline slowed to less than a third of the monthly average of 560,000 seen in the first half of the year. Taken as a whole, these data suggest that the longest and most severe recession since the 1930s may have finally ended in 2009.

Regardless of when the Business Cycle Dating Committee at the National Bureau of Economic Research officially deems the recession over, the economy remains burdened with some ongoing frictions. Jobs are still being cut. The amount of home foreclosures and bank-owned residential real estate is still on the rise, which could mean that the progress being made against the huge stock of unsold homes may not be as great as the most recent patterns indicate.

Estimates of growth in the third quarter of 2009 showed the influence of the American Recovery and Reinvestment Act of 2009 (ARRA), which provided \$787 billion in fiscal stimulus spread out over 2009 and 2010 and included funding for state fiscal relief, individual tax cuts, payments to seniors, aid to directly affected individuals, business tax incentives, and government investment outlays.

The act also included the U.S. Department of Energy's "cash for clunkers" program that spurred billions of dollars of new auto sales over the summer. In fact, the U.S. Bureau of Economic Analysis estimated that about half of the third quarter GDP gain came from auto output. Other government estimates project that ARRA contributed between 2 and 5 percentage points to economic growth over the second and third quarters of 2009, which would account for a significant share of the improvement in real GDP growth experienced over the two quarters.

### Contributions to Real GDP Change

Recession	Business						Real GDP	Employment Growth
	Consumption	fixed investment	Residential investment	Inventories	Net exports	Government		
<b>1960-61</b>	3.2	0.8	0.5	2.1	-0.5	1.4	<b>7.5</b>	2.8
<b>1969-70</b>	3.4	0.5	1.1	0.4	-0.3	-0.6	<b>4.5</b>	1.8
<b>1973-75</b>	3.9	0.1	0.9	1.6	-0.8	0.5	<b>6.2</b>	2.4
<b>1980</b>	1.5	1.1	-0.1	2.6	-0.8	0.3	<b>4.5</b>	1.7
<b>1981-82</b>	4.2	1.1	1.6	2.0	-1.6	0.4	<b>7.8</b>	3.4
<b>1990-91</b>	1.9	-0.3	0.5	0.3	0.2	0.1	<b>2.6</b>	-0.4
<b>2001</b>	1.3	-0.7	0.3	1.1	-0.9	0.7	<b>1.9</b>	-0.5
<b>Average</b>	2.8	0.4	0.7	1.5	-0.7	0.4	<b>5.0</b>	1.6
<b>Earlier five</b>	3.2	0.7	0.8	1.8	-0.8	0.4	<b>6.1</b>	2.4
<b>Last two</b>	1.6	-0.5	0.4	0.7	-0.3	0.4	<b>2.3</b>	-0.5

Note: Data represent a seasonally adjusted, four-quarter average annual percentage rate following a business cycle trough.  
Source: U.S. Bureau of Economic Analysis and the U.S. Bureau of Labor Statistics

### What are recoveries usually like?

What lies ahead for the U.S. economy? Perhaps history can be a guide. The table shows the components of economic growth during the first four quarters of an economic recovery for all seven recoveries since 1960.

On average, the economy has grown 5 percent during the first year of recovery, or 1.8 percentage points faster than the typical growth rate in the past 49 years. Of course, this performance is merely an average. During this period, the United States experienced first-year GDP growth rates as high as 7.8 percent (1982–83) and as low as 1.9 percent (2001–02). So this average includes a very wide range of observed outcomes.

An optimist might be encouraged to know that the deeper the preceding recession, the stronger the first year of recovery tends to be (see chart 2). The observation that the two most recent recoveries—the ones that began in 2002 and 1991—were very modest might be because these recoveries followed relatively modest recessions.

What distinguishes a strong recovery from a weak one? In the two most recent recoveries, a notable deviation from the past was the relatively slow growth of consumption coming out of recession. During the recoveries from the preceding five recessions, consumers added 3.2 percent to real GDP growth. In the most recent two recoveries, consumers added only about half of that amount to real GDP growth.

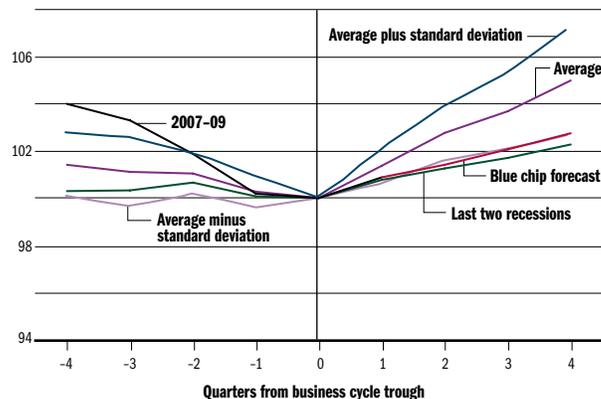
But the recent slow-growth recoveries weren't just about a shift in the behavior of consumers. The last two recoveries also were accompanied by weaker-than-average business spending on capital and inventory accumulations. In other words, most dimensions of private domestic spending were unusually weak during the last two slow-growth recoveries, suggesting that whatever was restraining the recovery relative to history, may be relatively pervasive.

Economists often refer to cyclical and structural forces that affect business activity. How they classify these terms isn't always so clear. The basic assumption is that cyclical forces only temporarily distort the economy, but structural forces push it to a new place entirely. Ongoing shifts in the composition of production toward service, the dramatic changes in the labor force participation of women, and rising global trade are some of the more obvious structural changes affecting national output in the past 30 years. Some economists—but by no means all—believe that a large structural force was at work during the last two recessions and that the ensuing recoveries slowed as the economy made a transition to a new state.

### So why doesn't it feel like a recovery?

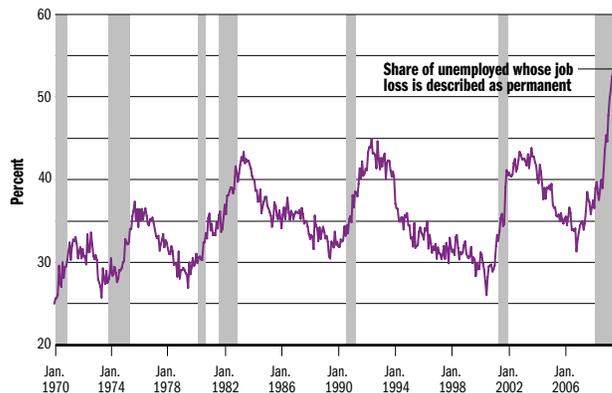
If the recovery has indeed begun, what kind of recovery should we expect this time? Given that the recent recession surpassed anything experienced in the United States in the past 80 years or so, prospects for a stronger-than-usual recovery would seem to be high. But the consensus among most economic forecasters is

Chart 3  
Real GDP Growth Around a Business Cycle Trough



Notes: Data are indexed so the trough equals 100.  
Source: U.S. Bureau of Economic Analysis, Blue Chip Panel of Economic Forecasters (Oct. 10, 2009)

Chart 4  
Workers Permanently Separated From Jobs



Notes: Data are through October 2009. Gray bars indicate recessions.  
Sources: U.S. Bureau of Labor Statistics, Federal Reserve Bank of Atlanta

that this recovery will be every bit as modest as those in 1991–92 and 2002–03 (see chart 3).

It's not very hard to see the basis for such pessimism. The housing market appears to have stabilized, but home prices remain depressed relative to their recent peaks. The sharp drop in home values combined with losses on financial assets have cut deeply into household wealth, weakening personal balance sheets more than in any recession on record—including the Great Depression. If consumers are more inclined to rebuild their wealth rather than increase their spending, recovery could be slow relative to historical experience.

Further, while credit markets are much improved relative to a year ago, full financial market function is not entirely restored. Bank balance sheets remain under stress, and some channels of

credit remain impaired. This stress could be a particular problem for small businesses, which tend to be heavily dependent upon the banking sector for funds. Very small businesses (those employing less than 50 workers) accounted for about 41 percent of the job losses during the recession, according to the U.S. Bureau of Labor Statistics—five times their share of job losses in the 2001 recession. These same businesses have tended to contribute about one-third of the job growth during expansions.

The data provide more than a few hints that structural adjustment has played a role in this recession, suggesting that the recovery may be slow to play out. The proportion of unemployed workers who report that they have been permanently separated from their job recently topped 55 percent (see chart 4 on page 5). This figure compares with peaks of about 45 percent in the last two recessions when much structural adjustment was thought to be occurring in the economy.

Whether this recovery is dominated by structural or cyclical forces also has important implications for the inflation outlook. Ordinarily, a sharp contraction in business activity would prompt economists to mark down their inflation forecasts as weak production and slow wage growth exert downward pressure on prices.

But an economy dominated by structural adjustments may not react exactly this way. Structural adjustment implies that the economy's potential output could have shifted downward, which leaves more possibility for upward price pressure than the usual measures would suggest.

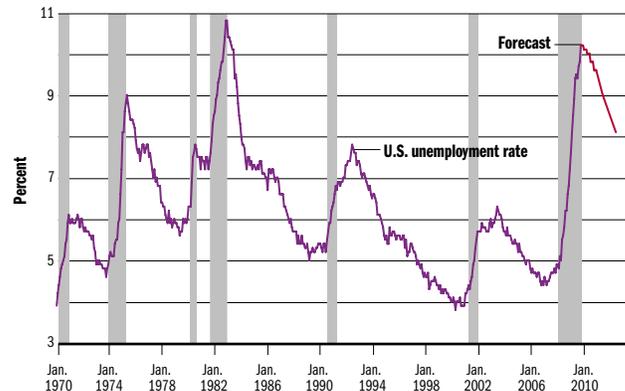
### Looking ahead to 2010

The consensus among business economists is that inflation will bottom out around 1.5 percent in the first half of 2010 and will rise to around 2 percent by the end of the year as the recovery gains more momentum. But even within this consensus, considerable disagreement exists over where the inflation trend is headed. Presumably, the degree to which structural changes are influencing the economy's potential is a focal point in that debate.

A potential implication of the slow-recovery scenario is that labor markets could be under stress for quite a while. Indeed, some economists anticipate that this recovery could be similar to the previous two: jobless.

A jobless recovery occurs when productivity growth accounts for a large share of the growth in real GDP. Why would firms hire more workers if they can satisfy increased production from their existing workers? And if job growth doesn't keep pace with the growth of the labor force, the unemployment rate could continue to rise well into the recovery, a scenario many economists expect. Chart 5 includes the Blue Chip consensus forecast for the civilian unemployment rate during the next several years. In this projection, the unemployment rate doesn't peak until the first quarter of 2010—which may be three quarters into the recovery—and only gradually recovers thereafter.

Chart 5  
U.S. Unemployment Rate



Note: Data are through October 2009. Gray bars indicate recession. Forecast is through December 2010.  
Sources: U.S. Bureau of Labor Statistics, Blue Chip Economic Indicators (Nov. 10, 2009)

Might the consensus forecast be wrong? Absolutely. Every economic forecast has to be viewed with a fair amount of skepticism. Even the most sophisticated economic model can be inadequate to predict what will happen to an economy that is as complex and dynamic as that of the United States. But forecasts nevertheless can be valuable in pointing out risks that could be especially important for prospects in 2010.

Near the top of the list of variables must be the influence of economic policy. As noted earlier, policymakers' response during the financial crisis was extraordinary. And extraordinary policies' effects are obviously hard to gauge.

Another risk is the effect of the headwinds working against a strong recovery—the fragility in financial markets, higher rates of personal saving, slow growth in small business, and ongoing structural adjustment. Additionally, shocks to the system—coming from looming losses in commercial real estate, rising commodity prices, or from sources not yet on the economic radar—introduce a potential setback to any budding recovery. Though the future is far from mapped out, it seems as if the economy has finally begun to show signs of rebuilding and repair after the storm. ■

*This article was written by Mike Bryan, a vice president and senior economist in the Atlanta Fed's research department, and Laurel Graefe, an analyst in the Atlanta Fed's research department.*

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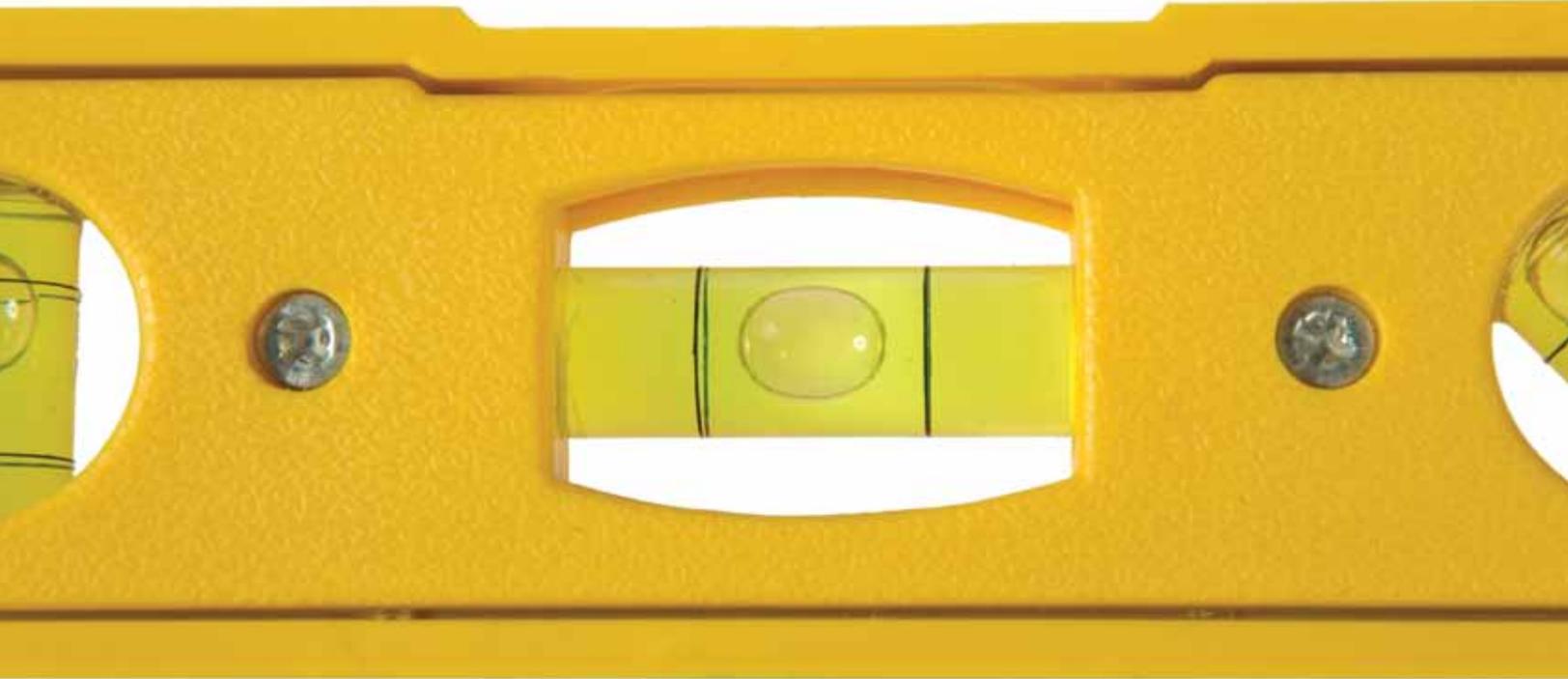
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# The Financial Sector Seeks Stability

Intense intervention into the financial system by the government including the Federal Reserve and other regulatory agencies loosened the grip of the economic crisis that dominated 2008. Sustaining the recovery is the focus for policymakers in 2010.



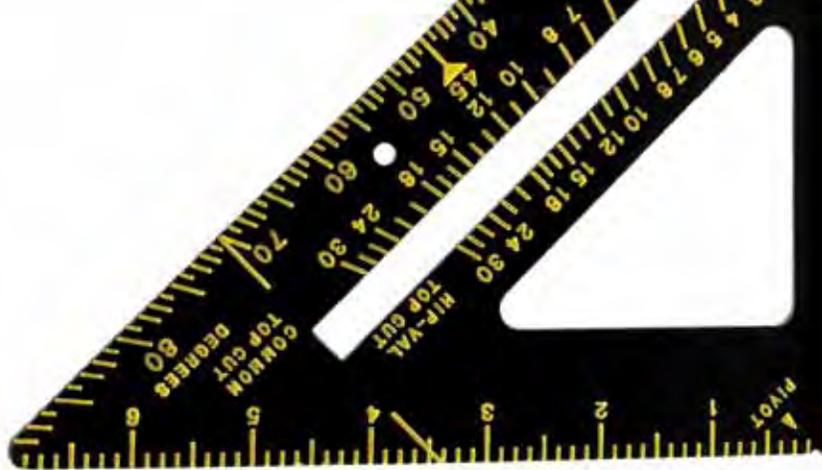
In 2009, the most severe financial crisis since the 1930s began receding. However, normalcy has not yet returned to financial markets, with many areas of the credit market and financial institutions still receiving support from government and other agencies. In addition, ongoing debt reduction among businesses and households could continue to constrain economic growth heading into 2010.

### Credit markets obtain stress relief

Many areas of the credit market underwent tremendous stress in 2008 and into 2009 before stabilizing and then improving during much of this year. For example, the LIBOR-to-OIS spread—a closely watched measure of short-term interbank strain—has dropped remarkably close to its precrisis level and is now at a small fraction of where it began the year (see chart 1). The CDX (an index of credit default swaps for investment-grade corporations) is nearly half of what it was at the start of the year, indicating reduced investor concern over default risk among top-rated companies. The risk spreads on asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) have experienced similar declines, indicating reduced risk premia for securitized credit instruments backed by consumer loans and commercial real estate loans, respectively.

Despite marked progress, financial markets still have some distance to go before they can be said to be functioning normally. Notably, some areas of the credit market are still relying on support from specially created Federal Reserve programs such as the Term Asset-Backed Securities Loan Facility (TALF). The TALF was designed to jumpstart the frozen securitization markets, which are important sources of credit for households and businesses.

Significant programs from the U.S. Treasury also remain in place, some of which provide general support to the banking



system. For example, through the Capital Purchase Program (CPP), the Treasury has purchased preferred shares of qualified financial institutions to improve banks' capital positions.

The TALF as well as other Federal Reserve programs designed to support commercial paper markets and money market mutual funds and provide short-term liquidity are scheduled to expire in the first half of 2010. While some institutions have repaid the government's CPP investment, many still have outstanding balances, and the CPP will stop funding transactions in October 2010. Market participants will likely pay close attention to how markets react as these and other banking sector and financial market support programs wind down.

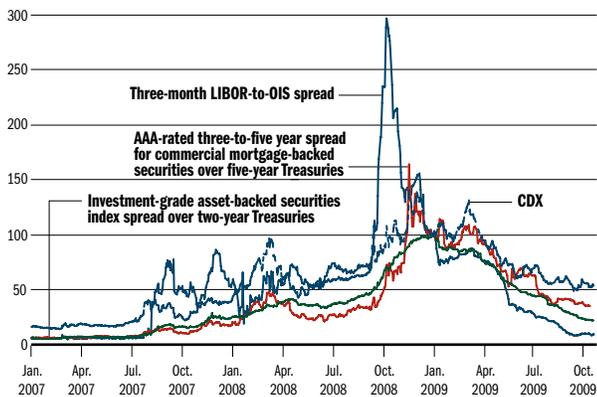
### Debt reduction under way

In 2009, households continued to whittle away at their debt by decreasing their use of credit. Federal Reserve data show that the amount of outstanding consumer credit has declined by 3.8 percent from its peak in July 2008 through October 2009, marking the largest decline since 1943. Additionally, the Fed's Senior Loan Officer Survey points to continued weak demand for credit from consumers while banks have tightened the standards and terms on many types of loans. Consumers' newfound distaste for debt indicates a greater reliance on current income to finance consumption. With the labor market likely to remain weak for some time and labor income unlikely to recover rapidly, a growing tendency toward a pay-as-you-go approach to spending decisions will provide additional headwinds to consumer spending.

On the corporate side, many businesses have enjoyed improved access to the bond market as indicated by robust issuance in 2009, declines in the cost of credit, and narrowing risk spreads. Bond investors have been more willing to come back to the market as average monthly issuance of corporate bonds more than doubled in 2009 (through October) to \$74 billion, compared with issuance in the second half of 2008 of about \$31 billion, according to the Securities Industry and Financial Markets Association.

However, Federal Reserve Flow of Funds data show that the amount of credit market debt outstanding among both financial and nonfinancial sectors has declined by a combined 2.1 percent from the fourth quarter of 2008 through the second quarter of 2009—the first six-month decline in the series' 57-year history. The contraction in business investment over 2009 and the sharp declines in the amount of short-term debt outstanding suggest that businesses are at least in part using bond sale proceeds as a

Chart 1  
Financial Market Risk Spreads, 2007-09



Note: Values are indexed so that Jan. 2, 2009, equals 100. Data are through Oct. 16, 2009.  
Source: Bloomberg, British Bankers' Association, Merrill Lynch, Markit Group, and author's calculations

## Southeastern Banks Endure Trying 2009

**B**anking in the Southeast continued to weaken during 2009 as the downturn in the economy persisted. Faced with high and rising unemployment, adjustable-rate mortgages that reset higher, and falling property values, many homeowners defaulted on their mortgages, turning banks into unwilling property owners. Community banks, which had readily lent money to builders and developers in booming housing markets during the economic expansion, faced declining earnings as borrowers fell behind in their payments and foreclosures increased. As a result,

bank expansion in 2009 nearly halted: Only two new banks opened in the Southeast as of early December compared with 23 opening in 2008.

### Consumers, businesses feel the lending squeeze

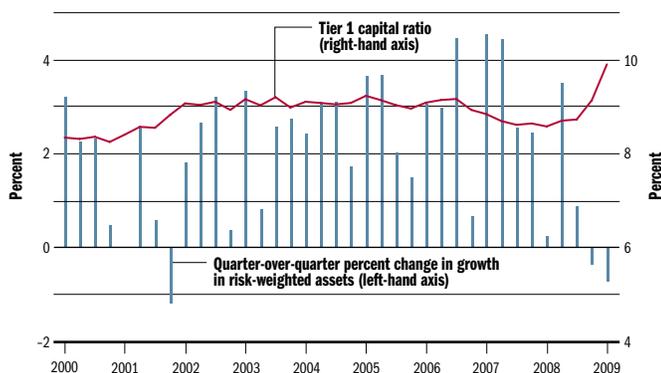
Credit remained tight as banks approved loans cautiously, subjecting borrowers to increased equity requirements, greater scrutiny of appraisals, and generally stricter credit standards. Once flooded with credit offers, in 2009 consumers saw offers of credit disappear and their existing credit limits reduced.

A corollary to this challenging situation is the current aversion of businesses and consumers toward taking on new debt, which is hampering some banks' ability to lend. Many sound banks would like to lend to creditworthy customers, but these customers are not seeking loans in the amounts they once did.

One bright spot was mortgage rates, which hit all-time lows, allowing many qualifying homeowners to refinance their existing loans at significantly lower rates. However, high-end home buyers had difficulty securing mortgages, and commercial contractors suffered from tight lending conditions, making it difficult to initiate new projects. As banks tightened credit, businesses faced challenges securing financing simply to maintain inventories.



Chart 2  
Large U.S. Banks' Capital Ratios and Asset Growth



Note: This chart defines a large bank as one with more than \$10 billion in assets. Data are through Oct. 22, 2009.  
Source: Federal Reserve Board

substitute for other funding, such as commercial paper and bank loans, or are refinancing maturing debt rather than making new capital investments.

Typically, expansionary monetary policy stimulates economic activity through the credit channel by making credit cheaper and more widely available for businesses and consumers. However, when financial markets don't function optimally and banks' reserves don't make their way to new loans, the flow of credit can be impeded. Indeed, from the supply-side perspective, banks have been reducing their loan portfolios and risk exposure to help boost their capital ratios (see chart 2). Moreover, the recent aversion of businesses and households to debt has reduced their demand for credit.

From a credit channel perspective, increases in measures of loan activity and credit line usage will be important tools for monitoring sustained improvements in economic activity and the potency of monetary policy. Ultimately, these signals will likely show up in broader measures of economic growth through increases in business investment and household consumption.

### Looking ahead to 2010

Even though the functioning of financial markets has significantly improved, risks to the outlook remain. Many individuals, includ-

### Failures spread widely

Bank failures, while rare earlier in the decade, have recently had a serious impact on the Southeast. From 2000 through 2007, seven banks failed in the region. However, seven failed in 2008 alone, and through early December 2009 there have been 38 failures in 2009 in the Southeast. The failures were concentrated in metropolitan Atlanta and the coastal regions of southwest and southeast Florida. More than one quarter of all U.S. bank failures so far in 2009 have been in three Southeastern states.

Banks continue to tighten or maintain stringent credit standards, and most expect their lending standards to remain high well into 2010. Already weakened by loan losses from the housing market, banks may face additional losses from the commercial real estate market as delinquency rates on these loans rise. The outlook for the banking industry remains cautious as regulators anticipate that the number of problem banks and failures will remain elevated even after an economic recovery begins. ■

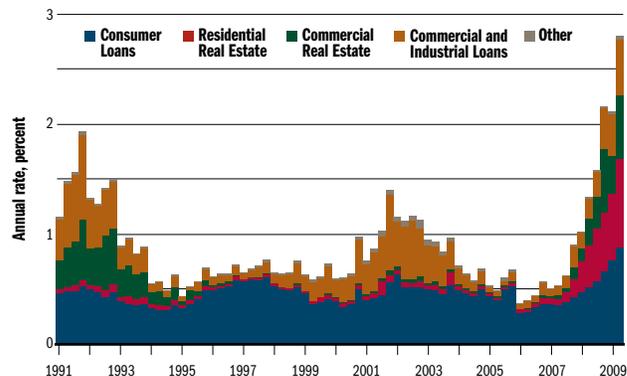
*This article was written by Pam Frisbee, an analyst in the Atlanta Fed's research department.*

ing Federal Reserve Bank of Atlanta President Dennis Lockhart, have cited commercial real estate (CRE) as a considerable risk going forward, and much attention will likely focus on this market and on potential signs of renewed stress in the banking system.

Deutsche Bank estimates that \$247 billion in commercial mortgages will come due in 2010, \$296 billion in 2011, and \$338 billion in 2012. Additionally, Bloomberg News data show only about 2–3 percent of outstanding CMBS issued in 2006 and 2007 are backed by fully amortizing loans. The rest are either interest-only, partial interest-only, or balloon-type mortgages. The persistent refinancing schedule, combined with weak fundamentals surrounding CRE—such as declining property values, high vacancy rates, and weak employment—leaves significant uncertainty regarding the industry's finances. Furthermore, the CMBS market, which is an important source of credit for CRE (estimates suggest CMBS account for roughly 25 percent of commercial mortgages), has essentially remained closed since early 2008 to all but a handful of new deals in the late months of this year. Higher-than-expected losses on CRE loans could place additional pressure

Chart 3

### Contributions to Commercial Bank Loan Charge-Offs



Note: Data are through August 2009.  
Source: Federal Reserve Board

on banks' already stressed loan portfolios and could lead to further credit contraction.

Unexpected increases in losses on a variety of other collateral types on bank balance sheets also pose a concern. Federal Reserve data show that the delinquency rate on loan balances at commercial banks rose to 7 percent in the third quarter of 2009—the highest level in the series' history, which dates to 1985.

Perhaps even more worrisome is the pace of loan charge-offs, which are the loan amounts banks do not expect to recover; these sums are charged against loss reserves and removed from the banks' books. Virtually every loan category has seen a drastic increase in the pace of charge-offs, losses that restrain banks' ability to make new loans (see chart 3).

The performance of consumer and business debt will in part depend on how fast the labor market and the overall economy recover. A slower-than-expected recovery could lead to higher loan losses, which could further restrain credit and retard economic growth.

Despite significant improvement in financial markets, the financial system is still receiving an array of support. Many of the programs that were designed to achieve stability in the financial system will soon expire; the potential effects on the financial system will bear close scrutiny. The performance of loans on banks' balance sheets will also be an important barometer for their ability to lend. Indeed, increases in new lending activity will be important for monitoring the recovery, whose path remains fraught with potential pitfalls. ■

*This article was written by Mike Hammill, a senior policy analyst in the Atlanta Fed's research department.*



# Global Outlook Takes a Turn Toward Improvement

Economies around the world are emerging from recession, albeit at varying rates. Developing economies are bouncing back strongest, but they will need developed economies to rebound as well.

**A**fter falling into a deep recession a year ago, the global economy has begun to recover, buoyed by extraordinary fiscal and monetary stimuli. Led by developing countries, the global expansion should continue in 2010; however, as financial systems remain considerably impaired around the globe, most countries will likely experience slow growth in the near future. Importantly, sustaining the nascent recovery will require stronger private consumption and investment as governments' fiscal support fades. The risks to growth appear to be mostly on the downside, including financial fragility, rising unemployment, and increasing commodity prices.

## **Countries entered recession en masse**

The global economy fell into recession as the U.S. financial crisis intensified in the latter part of 2008 and quickly spread to other countries. Banks abruptly tightened credit, business confidence tumbled, companies slashed inventories in response to plunging orders, and world trade collapsed. Investors rapidly and indiscriminately withdrew capital from emerging markets, the dollar quickly appreciated, and commodity prices plummeted.

In response to the sharp and widespread economic contraction, governments around the world announced large fiscal stimulus packages while monetary authorities aggressively cut

## Imbalances Cloud the Southeast's Trade Outlook

The trade balance between the rest of the world and the United States and the Southeast has been in negative territory for years. But because imports have recently grown more slowly than exports, the trade balance has improved: By August 2009, the gap between the value of goods entering U.S. ports and those leaving U.S. ports fell to \$44 billion, down from \$73 billion a year earlier (see the chart). Similarly, Southeastern ports' trade gap in August reached \$4 billion, down from nearly \$11 billion in August 2008. However, as the national and regional economies recover from their economic slumps and imports pick up steam from increased consumer demand, the trade gap could return to previous levels. Unless exports also recover, the U.S. trade sector could present a drag on the economy's recovery.

### Import demand dries up

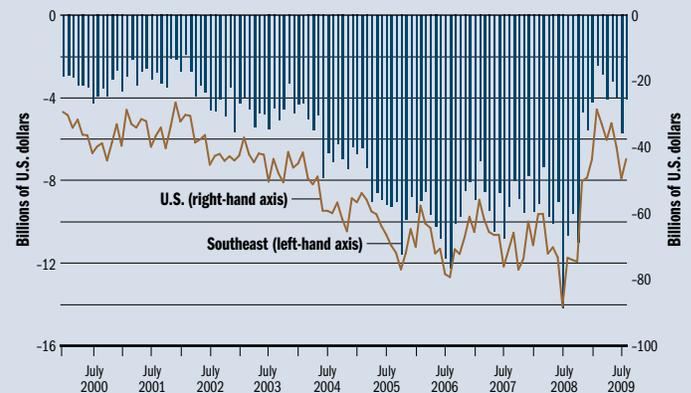
The value of international shipments passing through Southeastern ports deteriorated during 2009; exports and imports declined at double-digit rates, according to the U.S. Department of Commerce. Regional imports declined across most industry groups with oil, industrial machinery, autos, and chemicals leading the declines. Imports declined most in New Orleans, Tampa, and Miami. Shrinking domestic consumption sharply curbed imports from China, previously the engine of growth for most ports in the region. Lower demand has not only weakened port traffic and revenues across the region, but also has adversely affected support industries such as transportation and distribution services.

interest rates and adopted a wide range of unconventional easing measures. This extraordinary and internationally coordinated public intervention is widely credited with averting a collapse of the world financial system and a global depression.

### Fiscal, monetary stimuli appear worldwide

Among major countries, the United States implemented the largest fiscal stimulus, worth around 5 percent of gross domestic product (GDP). In Europe, fiscal packages have been smaller, around 1.5 to 2 percent of GDP. However, part of the difference in stimulus levels has been offset by so-called "automatic stabilizers" such as welfare payments and unemployment benefits, which are larger in Europe than in the United States. Fiscal support in Japan is expected to reach more than 4 percent of

### U.S. and Southeastern Ports' Trade Gaps



Note: Data are through August 2009.  
Source: U.S. Census Bureau

### Weaker U.S. dollar no match for weak demand

U.S. exports also deteriorated in 2009 as global economic conditions worsened. A weakened U.S. dollar made U.S. goods more competitive overseas, yet exports from all regional ports declined sharply in 2009. The greatest export declines were in Tampa, Savannah, and New Orleans, and these dropoffs were led by lower shipments of autos, chemicals, and industrial goods. All commodity exports dropped at double-digit rates in 2009.

Regional net exports, or exports from sectors with positive trade balances, have for many years supported economic growth

GDP. In developing countries, fiscal stimulus was generally smaller, with the notable exception of China. Its announced fiscal stimulus amounted to 4.8 percent of GDP, while related fiscal measures, such as direct bank lending implicitly guaranteed by the government, expanded dramatically. Globally, fiscal policies are projected to boost world GDP growth by at least 1 percentage point in 2009 and by less in 2010.

Although fiscal stimulus provided welcome support to the global economy, such policies came with a high cost. In many developed economies, budget deficits rose dramatically in 2009, with increases ranging from 5 percent of GDP (the European Union and Japan) to about 9 percent of GDP (the United States and the United Kingdom). Moreover, the average debt-to-GDP ratio in developed economies is now forecast to exceed 100 percent



by creating jobs and export revenues. During the last two years, only three industry sectors—food products (primarily agricultural and poultry), crude materials (including vegetable oils and scrap metal), and chemicals—posted positive net export values. Unfortunately, growth from these categories was not large enough to offset rising import values for products such as fuels, manufactured goods, and machinery and transportation equipment.

#### **Challenges in 2010**

Along with an expected national economic recovery, U.S. imports should rise in 2010 even though restraint among U.S. consumers could dampen the appetite for imports compared with past years. On the other hand, regional exporters

in the next few years. By contrast, many developing countries, whose precrisis debt-to-GDP levels were much lower than in the developed world, have more room for deficit spending.

Meanwhile, decreased inflationary pressures allowed for considerable easing of monetary policy. Central banks' interest rate cuts have averaged more than 300 basis points since financial turmoil began in August 2007. In most major developed economies, policy rates have been reduced to between 0.1 and 1 percent. In addition, major central banks have adopted a wide range of innovative policy measures, which have made monetary policy looser than policy rates alone reflect. For instance, many central banks have been buying government debt and other assets to increase the money supply and improve credit market functioning. In developing countries, monetary policy under-

will be able to take advantage of a weak U.S. dollar and remain competitive in world markets.

Also, the global economy's emergence from severe recession will likely mean that different economies will be at different stages of recovery, which will provide hurdles for exporters. For example, the U.S. dollar has not lost value evenly among currencies of key trading partners, such as those in Asia. Moreover, the trade gap for commodities such as oil and industrial goods will not be easily offset in the short term. It will likely be a while before U.S. and Southeastern exporters see a return to prerecession levels of activity. ■

*This sidebar was written by Gustavo Uceda, an analyst in the Atlanta Fed's research department.*

went less easing largely because of higher inflation and currency depreciations.

#### **China bounces back strongly**

Internationally, one of the main recovery stories of 2009 is China. In late 2008, a drop in exports caused China's growth to decelerate to the low single digits. The Chinese government responded with an outsized fiscal stimulus package aimed at increasing investment and consumer spending. In addition, bank lending was expanded dramatically, reaching more than \$1 trillion, or a fifth of China's GDP. Moreover, after several years of measured appreciation, China re-pegged the yuan's exchange rate to the U.S. dollar, helping preserve the competitiveness of the country's exporters.

Notably, the government's control over the economy made it easier to implement the stimulus measures and resulting acceleration in economic growth, which rose to nearly 9 percent in the third quarter of 2009. Because of improved domestic demand, China's imports increased, especially of raw materials, machinery, and equipment. This development had significant positive effects on China's trading partners in the rest of Asia and elsewhere in the world. Overall, China's renewed strong economic growth significantly boosted optimism about the global recovery.

### Other developing economies emerge from their slump

Although the financial crisis led to a simultaneous global economic downturn, developing and developed economies are now on divergent paths. The Economist Intelligence Unit, a research firm, is forecasting that emerging economies will reach their precrisis GDP levels well before developed economies do. While both types of countries have now emerged from recession, developing economies have rebounded more dramatically. Led by China and India, emerging Asia bounced back vigorously in the second quarter of 2008, with growth outpacing other regions. Asia's recovery is being driven by domestic demand, stimulated by increased government spending and looser monetary policy. In addition, inventory rebuilding in many parts of the world is also providing a boost to Asia's exports.

Economic expansion is also under way in developing economies outside of Asia. For example, Brazil proved relatively resilient in this recession, and its recovery is progressing. Elsewhere in Latin America, rising commodity prices are boosting growth. By contrast, recovery is lagging in Eastern Europe, mainly because past borrowing excesses constrained new credit growth. As a group, developing countries are expected to grow around 5 percent in 2010 (see chart 1). However, given the considerable dependence of developing countries on export growth, the speed



of next year's expansion will depend significantly on the developed world's economic prospects.

### Developed economies get back on their feet

Most developed economies began to expand in the second half of 2009. Germany, France, and Japan were the first to bounce back, with growth turning positive in the second quarter. Although growth resumed in those countries sooner than it did in the United States, the recessions were much deeper in Germany and Japan, so it will likely take significantly longer for their economies to return to precrisis levels.

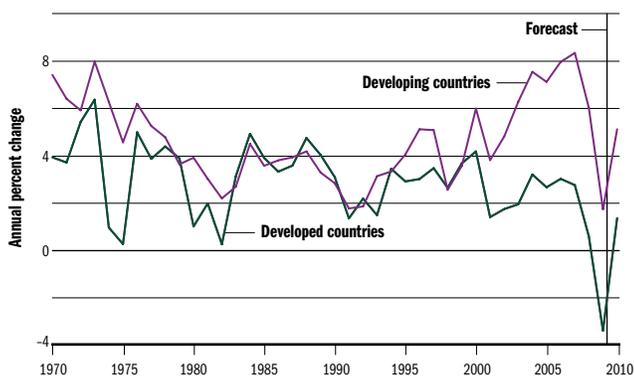
The economy in the United Kingdom has not yet returned to positive growth, raising the possibility of an extremely shallow recovery next year.

In the United States, economic growth turned positive in the third quarter of 2009 on the back of strong fiscal support, but the recovery going forward is generally expected to be relatively lackluster. Overall, growth in developed countries is forecast to remain subdued in 2010, rising to only slightly above 1 percent.

### Looking ahead to 2010

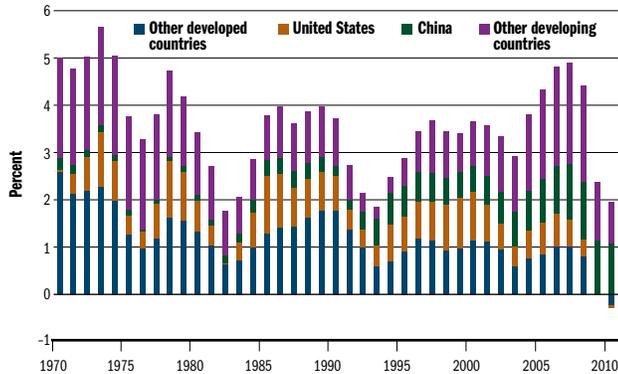
Although the global economy has begun to recover, the rebound has been mainly driven by stimulative government policies. To ensure the sustainability of this recovery, consumer spending and private investment need to pick up as the boost from government spending and inventory rebuilding winds down in the coming year. However, consumer spending is likely to remain constrained by high unemployment and slow income growth. Households are now in the process of repairing their balance sheets, likely a lengthy process that will dampen consumption. Meanwhile, industrial capacity utilization rates, having recovered from record lows toward the end of 2009, remain below

Chart 1  
Global GDP Growth



Note: Data are through August 2009, and the forecast is through 2010.  
Source: International Monetary Fund

Chart 2  
Contribution to Global GDP Growth



Note: Data represent a three-year moving average and are through August 2009. The forecast is through 2010.  
Source: International Monetary Fund

historical averages in many countries. Consequently, business investment and hiring likely will remain weak in the near term.

The health of the banking system remains a key concern: Banks are likely to see more write-downs from continued mortgage and credit card defaults and corporate bankruptcies. Because the global recession considerably weakened commercial property markets, defaults on commercial real estate loans have been rising rapidly in many countries, threatening financial institutions that have considerable exposure to those markets. Other impediments to growth include higher oil and other commodity prices and increasing protectionist pressures as unemployment continues to rise.

History suggests that recoveries after financial crises tend to be slower than after recessions that don't involve financial turmoil. Given the extent of damage to financial systems in this recession, global growth will likely remain subdued at around 3 percent in 2010 and subject to numerous downside risks. While the developed world struggles to recover, China, India, and other developing countries will continue to lead the global recovery, increasing their contribution to world economic growth (see chart 2). ■

*This article was written by Galina Alexeenko, a senior economic analyst in the Atlanta Fed's research department. The international estimates and forecasts represent a consensus of private-sector or multilateral outlooks and are not those of the Federal Reserve Bank of Atlanta or the Federal Reserve System.*

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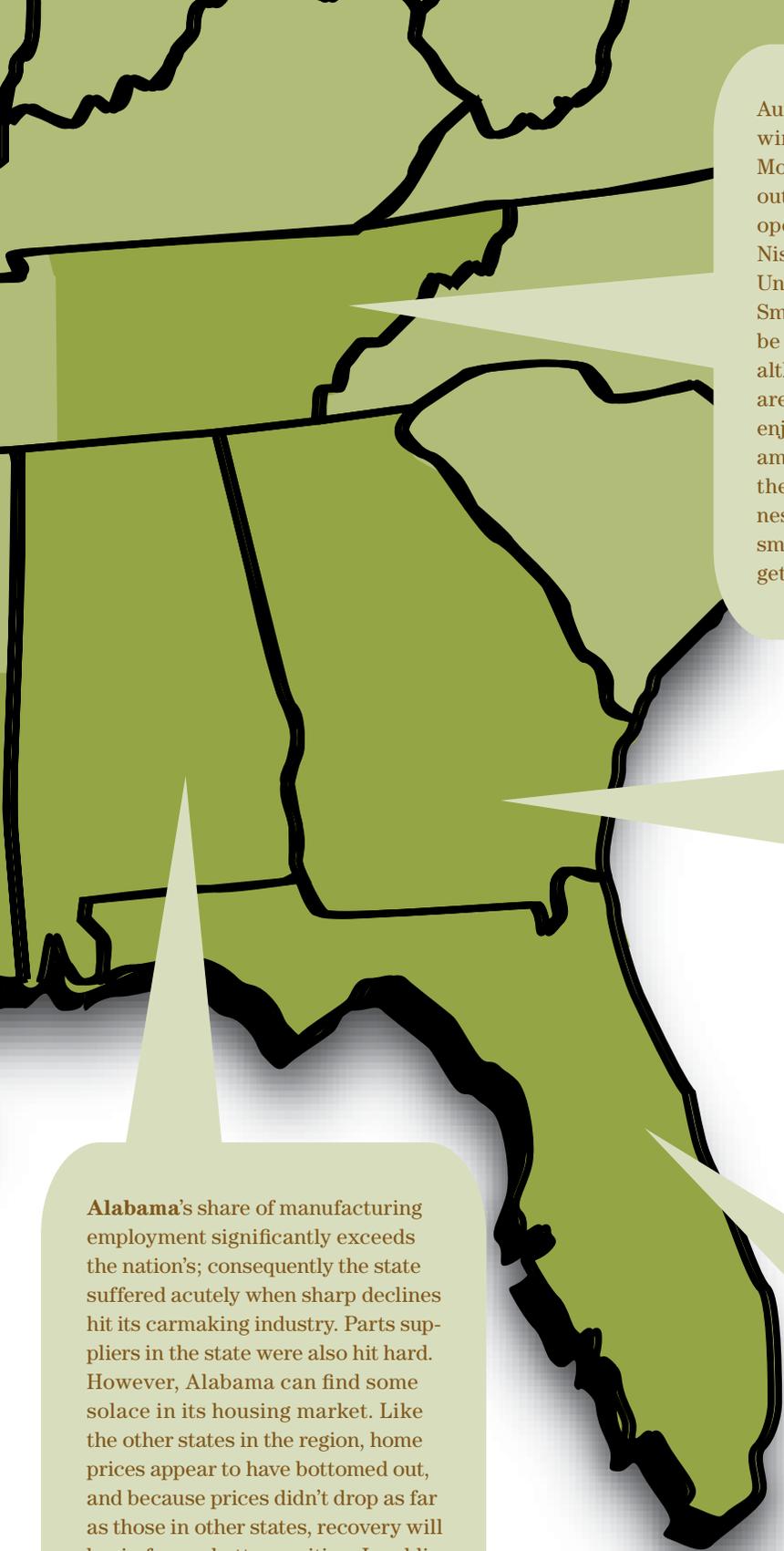


# The Southeast in 2010

The region, like the rest of the United States, weathered a difficult year in 2009, but indications of a turnaround in the economy suggest a less rocky 2010. However, daunting challenges remain before Southerners can be confident of a full and lasting recovery.

Job losses and lower incomes contributed to **Mississippi's** ongoing decline in gaming revenues, which was a significant factor in the state's anticipated budget shortfall. Like other Southeastern states, Mississippi expects revenues to be considerably short of the amount needed to balance its budget. Also, the auto industry's woes hurt the state because Toyota has put on hold plans to start production in Blue Springs until the company decides which vehicle to produce there. But agriculture has been robust: As the region's leading producer of soybeans, Mississippi is benefiting from the global increase in demand for the crop.

**Louisiana** succumbed to job losses in 2009—the last state in the region to begin shedding jobs during the recession. However, the state's unemployment rate remains below the national average. Shreveport felt the auto industry's woes when General Motors stopped producing Hummers there and when it learned of GM's plan to close the Norwest plant by 2012. However, developments were not uniformly bad: New Orleans benefited from “stay-cationers” choosing to spend vacations closer to home, and attendance rose at all of the city's major festivals in 2009.



Auto production in **Tennessee** is a win-some, lose-some story. General Motors is moving its production out of the state, but Volkswagen is opening a new plant in Chattanooga. Nissan is gearing up to produce the United States' first electric vehicle in Smyrna. Overall, the state appears to be on the winning side. In addition, although commercial vacancy rates are climbing regionally, Nashville is enjoying the lowest vacancy rates among major metropolitan areas in the Southeast. Significantly, Tennessee is looking at the Southeast's smallest shortfall among state budgets for the current fiscal year.

While **Georgia** will benefit in the coming years from the arrival of some high-tech jobs, it has suffered among the largest number of job losses in the nation in 2009. The state is also home to one-fifth of all failed U.S. banks. A sign of hope came in the moderating decline of home sales from 2008 levels. In addition, as the region's leading poultry producer, Georgia benefited from a slight increase in poultry exports in 2009.

**Alabama's** share of manufacturing employment significantly exceeds the nation's; consequently the state suffered acutely when sharp declines hit its carmaking industry. Parts suppliers in the state were also hit hard. However, Alabama can find some solace in its housing market. Like the other states in the region, home prices appear to have bottomed out, and because prices didn't drop as far as those in other states, recovery will begin from a better position. In addition, although the amount of vacant office space in Birmingham rose early in 2009, the city's office market stabilized through the remainder of the year.

In much the same way as it preceded the region into recession, **Florida** has been on the leading edge of showing signs of recovery. The state is the only one in the region to lose considerably fewer jobs through the third quarter of 2009 than during the same period in 2008. In addition, home sales rose significantly at the end of the year compared with the end of the previous year, and new home construction is starting to show a pulse. However, Florida still faces challenges, including bank failures primarily stemming from woes in the construction sector, and the state's lucrative citrus industry struggles with disease. Citrus production has declined in 2009 for the second consecutive year.

# Auto Production Hits Bumps in the Southeast

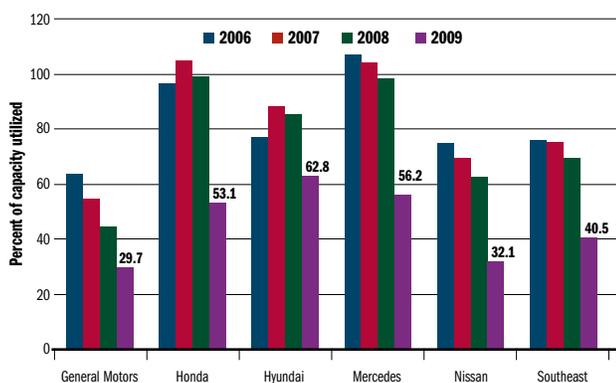


Vehicle manufacturers in the United States lost traction in 2009 as the recession took a toll on the region's auto assembly plants, which collectively experienced one of their worst years in decades. Through September 2009, regional auto production fell 43 percent compared with September 2008, according to MonthlyAutocast.com, with most assembly plants producing well below their capacity. Southeastern plants' average utilization rates, defined as the share of vehicle production volume in relation to a plant's capacity, dropped to 41 percent in September 2009 compared to 69 percent a year earlier, according to MonthlyAutocast.com (see chart 1).

## Falling sales, fewer workers

What led to this decline in production is no mystery: weak and falling sales. Sales of vehicles assembled in the Southeast through September 2009 fell 28 percent from comparable 2008 levels; the nation's comparable sales decline was 27 percent.

Chart 1  
Southeastern Auto Plants' Utilization Rates



Note: Data cover January through September of each year.  
Source: MonthlyAutocast.com

Regionally, new vehicle registrations during the 12-month period ending August 2009 declined 34 percent from the same month a year earlier while national comparable registrations dropped 29 percent (see chart 2).

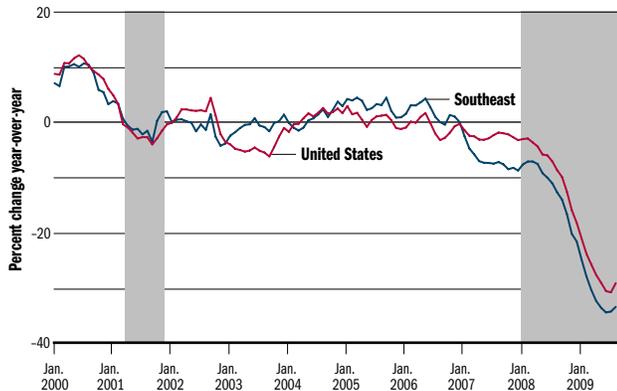
Lower production during the year also meant lower employment.

In early 2008, auto assembly plants in the region employed about 24,800 workers. After downsizing work forces and idling plants, the job count was down to about 21,200 jobs by late 2009—a 16 percent decline in relatively high-paying factory jobs. Additionally, parts manufacturing jobs in 2009 numbered 58,000, down from 73,000 workers at the beginning of 2008, a 20 percent drop, according to the U.S. Bureau of Labor Statistics.

## Most industry forecasts call for vehicle sales and production in 2010 to be much lower than the peak levels of 2006–07.

Two regional assembly facilities hardest hit by the economic downturn were General Motors's (GM) Shreveport, La., and Spring Hill, Tenn., plants, which face uncertain futures. As part of its plan to emerge from bankruptcy, GM eliminated some brands and placed its Saturn and Hummer brands up for sale. Chinese investors in October 2009 signed an agreement to buy the Hummer brand, which is manufactured in Shreveport; GM's Shreveport plant would continue to produce Hummers until June 2011. The Shreveport plant also assembles two other truck lines, and GM plans to close the northwest Louisiana plant by 2012.

Chart 2  
New Vehicle Registrations



Notes: Data are through August 2009. Gray bars indicate recessions.  
Source: R.L. Polk Company/MEDC

GM's Spring Hill plant, originally constructed to produce Saturn vehicles, halted production of its single product line, the Chevrolet Traverse crossover, in November 2009; it had begun making them there in the third quarter of 2008. Production of this crossover utility vehicle (CUV) moved to a Michigan plant in November 2009, and GM placed the Spring Hill facility on stand-by status. Recently, the sale of the Saturn brand fell through when Penske Automotive Group Inc., a large automotive retailer, couldn't find a manufacturing company willing to continue making Saturns after GM stops their production, currently done only in Mexico.

Changing consumer preferences have also posed challenges to the region's four transplant manufacturers: Honda, Mercedes, Nissan, and Hyundai. The reliance of those manufacturers on a production mix of mostly full-size SUVs and trucks, which have fallen out of favor with car buyers, was one reason for their difficulties. Data from MonthlyAutocast.com show that during 2009

these plants were not immune from the industry's low rates of utilization.

### Looking ahead to 2010

The outlook for Southeastern auto production in 2010 is mixed. Factors such as imbalances among vehicle production and consumer demand, tight credit markets, and low consumer confidence will continue to limit discretionary spending on autos and thus production flows. Most industry forecasts call for vehicle sales and production in 2010 to be much lower than the peak levels of 2006–07. Production levels were boosted during summer 2009 by the “cash for clunkers” program, but manufacturers endured the ensuing hangover with disappointing traffic after the program ended. Most industry forecasters expect retailers to sell between 11 million and 12 million cars nationally in 2010, a sizable drop from the 16 million–17 million sold in 2006–07.

In the longer term, the region's auto production outlook holds more promise than recent years have seen. Regional carmakers are adjusting their production schedules downward to reflect shrinking demand and taking measures to boost productivity, such as the addition of more fuel-efficient models as they strive to capture the attention (and market share) of environmentally conscious car buyers.

Foreign carmakers will occupy an increasingly important role in the region. After 2010, the arrival of Volkswagen and Toyota will further enhance the region's production capacity. The two carmakers plan to add 300,000 new vehicles to the region's production capacity in Tennessee and Mississippi by 2011 and 2012, respectively. And Kia Motors began production of its Sorento model this year at a new plant in West Point, Ga.

In Mississippi, Toyota has built a new facility in Blue Springs, but the company put installation of production equipment on hold until vehicle demand improves. Initially, the company intended the plant to assemble the Highlander SUV but later decided to build the hybrid Prius there. However, falling gasoline prices in 2008 weakened demand for hybrids, and Toyota is not producing them there. According to recent information from *Automotive News*, Toyota's interest in producing the Prius in the United States is high since the Japanese yen is at historic highs against the U.S. dollar, and a stronger yen means the vehicles Japan exports for sale are more expensive.

Similarly, Nissan, which currently accounts for about two-fifths of the region's vehicle production, will start producing the Leaf model in Smyrna, Tenn., in late 2012. It will be the first U.S.-made electric vehicle (EV). Nissan is optimistic about the future of the Leaf and EV in general, expecting that by 2020 EV might make up about 10 percent of U.S. car sales. Nissan believes that the Leaf will be a hit with consumers and anticipates annual production of about 90,000 vehicles, or more than 10 percent of Nissan's projected U.S. production.



# Construction, Real Estate Still Shoring Up Foundations



The Southeast's residential housing market appeared to find its bottom during 2009, aided by the incentive that the first-time home buyer stimulus provided. Accordingly, low-end home sales dominated home sales activity, and although a price floor was apparently found, distressed property sales kept that floor low. In addition, commercial real estate market conditions continued to deteriorate. The economic slowdown increased commercial space availability while rental rates declined. Construction for residential and commercial remained at low levels regionally. Residential construction stabilized at low levels, but commercial activity continued to soften during 2009. Single-family housing permits in the Southeast reached their lowest level in more than two decades early in 2009 and experienced steady, albeit modest, improvement through the third quarter.

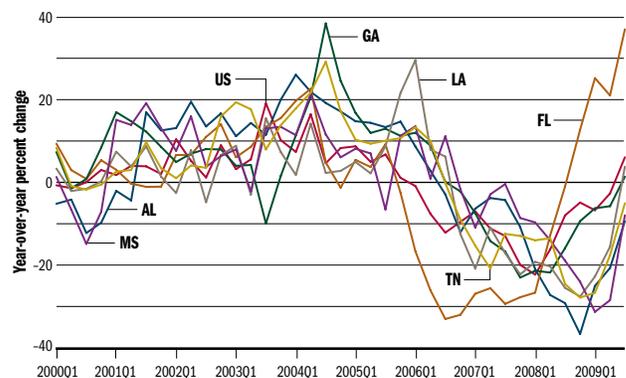
## Houses find a floor

Existing home sales in the region appeared to bottom out during the first quarter, with new home sales doing the same in the second quarter (see chart 1). Low mortgage rates, government incentives, and improvements in affordability began to spur demand, particularly in Florida housing markets. However, many builders and Realtors complained that tight lending standards and low appraisals put the brakes on many sales or stopped them altogether.

Despite sales improvements during the year, the growing number of foreclosed homes remained a drag on existing home prices (see chart 2 on next page). However, prices may have stabilized, particularly at the lower end of the market where the federal stimulus program helped create demand.

Atlanta Fed business contacts from across the region noted that demand for high-end homes remained weak during 2009, and home listing inventories continued to decline across the region. Moreover, foreclosures continued to mount as job losses grew and some homeowners faced the prospect of owing

Chart 1  
Existing Home Sales



Note: Data are through September 2009.  
Source: National Association of Realtors

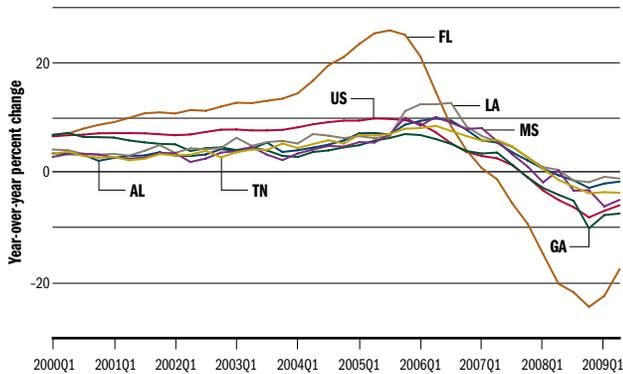
more than their homes are worth. As a result, REO (real-estate owned) inventories—homes owned by lenders because of foreclosure—continued to rise. By the third quarter of 2009 a large share of homes had not yet been placed on the market, which could become a further drag on prices.

## Florida's activity grows sunnier

Despite continued weakness, Florida housing markets in particular experienced increased activity during 2009. Sales of single-family homes continued to strengthen during the first quarter, exceeding the year-earlier level by 25 percent, according to figures from the Florida Realtors Association (FRA). Sales remained strong through the third quarter, up 33 percent from the same period last year.

Florida homebuilders reported an uptick in new home sales during 2009; construction also rose from low levels. Builders were reportedly constructing homes in the low-to-moderate range.

Chart 2  
Existing Home Prices



Note: Data are through 2009Q2.  
Source: Federal Housing Finance Authority

Condominium sales also improved during 2009, with strong increases compared with the weak levels of 2008. Third quarter sales increased 56 percent compared with a year earlier, the FRA reported. Condo price declines slowed in the third quarter but remained down sharply (34 percent) from a year earlier. Unlike the single-family housing market, no pick-up in multifamily permitting occurred.

Home affordability reached new highs during 2009 in Florida, which is a more positive way to view price declines. The Northeast Florida Association of Realtors reported that the housing affordability index for the Jacksonville area increased to 175 in September, its highest level in more than five years and up 28 percent from a year earlier. (A housing affordability index of 175 means that the income of a family in the median-income bracket has income that is 175 percent higher than would be necessary to qualify for a conventional mortgage on a median-priced home.)

Similarly, the Orlando Regional Realtors Association reported that the composite housing affordability index there increased to 202 percent, also its highest level in more than five years and up 63 percent from a year earlier. Cash buyers, attracted by price and seeking profit opportunities, became a larger share of home buyers, according to data from the Greater Tampa Association of Realtors and Orlando Regional Realtors Association.

### Once red-hot Georgia cools

Home sales remained weak in Georgia during 2009, but year-over-year declines moderated from their lowest levels in 2008. Existing home sales during the third quarter rose slightly on a year-over-year basis, up 1.2 percent, according to the National Association of Realtors. Foreclosed homes continued to put downward pressure on home prices, particularly in the Atlanta market. However, according to the S&P/Case-Shiller home price

index, year-over-year declines in Atlanta slowed during the third quarter of 2009 among single-family existing homes, down 9.4 percent.

Home construction remained slow in Georgia during 2009. Atlanta homebuilders, under intense pressure, found it difficult to compete with prices on foreclosed homes. A leader in single-family home permitting earlier in the decade, Atlanta's permit issuance remained anemic. U.S. Census Bureau data showed that Atlanta permitted 4,055 homes through the third quarter of 2009 compared with 46,220 in the same period during the peak year of 2005, a 91 percent decline. The remainder of the Southeast did not experience the same run-up in home sales, construction, and home prices seen in Florida and Georgia earlier in the decade so the declines were not as dramatic in those other states. However, access to financing and problems with appraisal values remained a challenge in 2009.

Even though affordability improved throughout the Southeast, it did not improve as much as it did in Florida and Georgia. As a result, new and existing home sales in 2009 remained below the year-earlier levels across much of the region, but sales declines abated. By the third quarter of 2009, year-over-year sales declines in Alabama, Mississippi, and Tennessee were only in single percentage points. Louisiana home sales improved slightly during the third quarter of 2009 compared with weak sales a year earlier, when hurricane activity stalled sales there. In Alabama, Louisiana, and Tennessee, the median home price remained slightly below year-earlier levels through the third quarter of 2009. In Mississippi, the median home price decline in the third quarter of 2009 was smaller compared with the same period a year earlier.

### Commercial real estate awaits a rebound

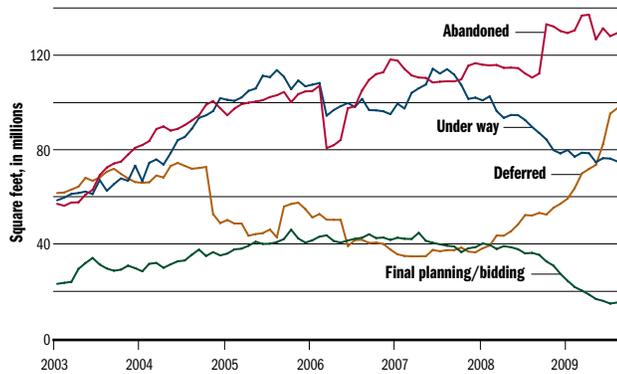
Commercial real estate markets (CRE) in the Southeast remained weak in 2009. Private construction activity hit new lows, and in the public sector government incentives stepped into the breach created by state and local government funding shortfalls. Vacancy rates continued to rise across the region, depressing rents.

The number of projects under way dwindled across the region as more projects were delayed or abandoned. Contractors reported that financing terms continued to tighten while weak demand for new space stalled many projects. Weakness was most pronounced in Florida and Georgia as those states accounted for three-quarters of the region's deferred and abandoned space in August (see chart 3 on the next page).

CRE activity remained weak elsewhere in the region. Even along the Gulf Coast, where rebuilding from Hurricane Katrina had buoyed construction activity since 2005, contractors noted greater competition for fewer projects during the third quarter.

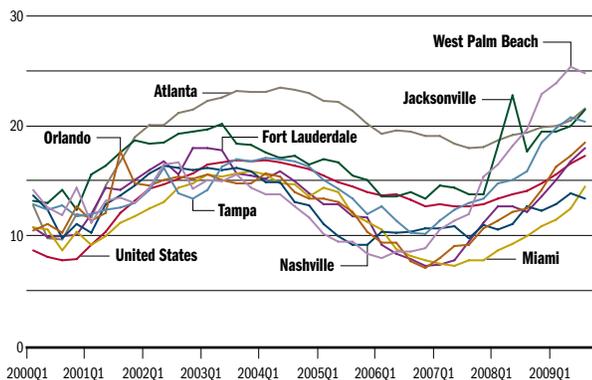
Demand for space softened in 2009, and commercial real estate agents described the market as challenging. Weaker

Chart 3  
Retail and Warehouse Construction in the Southeast



Note: Data are through August 2009.  
Source: McGraw-Hill/TWR Pipeline

Chart 4  
Metropolitan Office Vacancy Rates



Note: Data are through the third quarter of 2009.  
Source: CB Richard Ellis

consumer spending resulted in the closure of more retail space as companies shuttered underperforming stores or closed their doors altogether.

Office and industrial vacancy rates in the region crept up across most markets as layoffs mounted and companies focused on containing costs. Rental rates declined, and tenants focused on renegotiating short-term leases instead of extending leases on more favorable terms. Office vacancy rates that rose during 2008 continued climbing during 2009, with vacancy rates in the third quarter of 2009 surpassing those reported a year earlier, according to the real estate service firm CB Richard Ellis.

The most dramatic rise in office availability was in the Orlando, Miami, and Tampa markets, according to CB Richard Ellis. West Palm Beach had the highest availability, followed

closely by Atlanta and Jacksonville. The Nashville market had the lowest availability, up only slightly from a year earlier (see chart 4).

The Birmingham office market experienced a surge in sub-lease space early in 2009, Atlanta Fed industry contacts noted, but by the third quarter rents stabilized and availability rose slightly from the second quarter. Contacts also described the New Orleans office market as stable.

Southeastern industrial vacancy rates climbed in 2009, according to CB Richard Ellis, but the rise was more modest than in the office sector. Absorption of space remained weak, but the dramatic slowdown in industrial development meant that several regional markets had more moderate levels of growth in vacancies.

The vacancy rate remained highest in the Atlanta market, where warehouse space was particularly hard hit. The Nashville market had good news as net absorption picked up notably, with warehouse and distribution space accounting for most of the gains. Slowdown in the flow of cargo through Southeast ports led to increases in warehouse availability.

#### Looking ahead to 2010

In the coming year, Southeastern housing markets will continue their recovery, but activity will remain weak by historical standards. REO properties will continue to come to market, particularly in Florida and Georgia, and will continue to depress home prices and keep construction activity in check. Homebuilders have found it difficult to compete against REO properties that have typically sold below replacement cost.

The federal stimulus should help support the housing market through the spring. Greater affordability will continue to be a major driver of market improvements while tight lending standards will continue to restrain activity somewhat.

Southeast CRE markets will remain challenging in 2010 although activity should stabilize and slowly improve during the year. Construction backlogs are currently at very low levels across most of the region and financing is likely to remain tight, particularly for CRE projects. Consequently, commercial development should remain at low levels, and projects will remain largely build-to-suit.

Improvements in economic conditions are expected to occur slowly, and leasing activity will likely follow suit. Incrementally small improvements in vacancy absorption should occur next year in the Southeast, and firming in rents will likely take hold by late 2010 because the supply of new space will remain limited.

# Consumers Continuing Thrifty Ways



Through all of 2009, consumer spending has been buffeted by job losses, wealth depletion, historically slow income growth, and low confidence. Spending might have been even lower without the American Recovery and Reinvestment Act of 2009 (ARRA), which appears to have helped prop up income. Hopeful signs for 2010 appeared toward the end of 2009, with better-than-expected back-to-school sales and an uptick in personal consumption expenditures.

## Consumer spending continues to fall

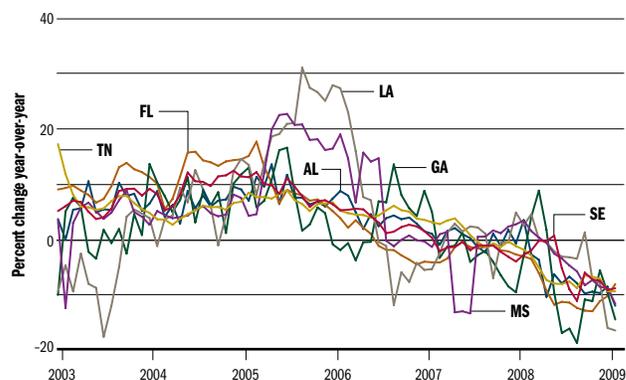
The recession, which began in December 2007, dragged consumer confidence to critical lows and caused consumers in the Southeast, the United States, and all over the world to reduce spending and start saving more of their income, choking off states' sales tax revenue (see chart 1).

September 2009 sales tax revenue fell on a year-over-year and month-to-month basis throughout the Southeast. In the region, only Florida's sales tax revenue declined at a slower annual pace than in August. Overall, sales tax revenue in the region was down 9 percent from a year earlier, according to the states' departments of revenue.

## Southeastern retailers didn't have a lot to feel good about in 2009 as declining sales, traffic, and prices offered little hope for improvement.

On a month-to-month basis from September to October, sales tax revenue in Mississippi declined at a slower pace than the previous month while Alabama, Georgia, Tennessee, Florida, and Louisiana's tax revenues continued to decline at faster

Chart 1  
Sales Tax Revenue in the Southeast, 2003-09



Note: Data are through September 2009 and represent a three-month moving average.  
Sources: State departments of revenue (Ala., Fla., Ga., La., and Tenn.) and Mississippi's State Tax Commission

pace from September to October than they did a month earlier. Regional sales tax revenue declined 5.8 percent in October from September.

The region's decline in sales tax revenues is a result of the reduction in consumer expenditures that occurred across all components of personal consumption expenditures, the consumer spending component of the gross domestic product. The largest year-over-year declines, however, came among the generally more expensive category of durable goods (see chart 2 on page 28).

## The culprit: Personal income

Of course, consumers aren't inclined to spend when they feel less wealthy than they used to. Historically high job losses and dramatically lower stock markets have contributed to diminished spending.

In the second quarter of 2009, real personal income growth—earnings, dividends, interest, rent, and transfer payments—

## Exports Brighten the Region's Farm Outlook

The United States is the world's largest exporter of agricultural goods. In the Southeast, export farm sales account for a growing share of total farm revenues, and four agricultural industries have produced trade surpluses thus playing a role in reducing the nation's trade gap. As the U.S. economy embarks on a challenging new year, these industries could play a supporting role if they retain their status as net exporters.

### Poultry's surplus travels the globe

Poultry is the region's leading cash-producing sector, with more than \$10 billion in cash receipts in 2008 (see chart 1) and the region's largest net export producer. About 14 percent of the poultry industry's output in the Southeast leaves the United States; Russia is the leading market. Through August 2009, the net value of poultry exports from regional ports reached \$1.4 billion, slightly higher than in the first eight months of 2008 (see chart 2).

Poultry sales to the region's top export markets, Russia and China, have recently declined from high levels in 2008, according to the U.S. Department of Agriculture (USDA). Fortunately, smaller markets like Mexico, Lithuania, and Central American countries offset reduced regional sales to Russia and China. The USDA estimates that by 2010 poultry exports should benefit from improvements in global economic conditions and the weaker U.S. dollar, which should make poultry products more affordable to global consumers.

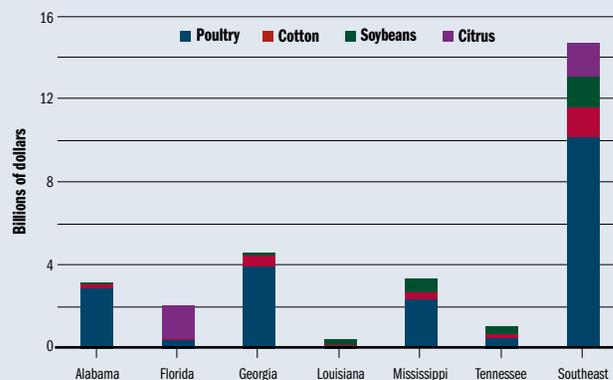
### Cotton still a net export king in some markets

Another regional cash crop, cotton, plays an important export role. In 2008, cotton growers in the Southeast reported about

decreased in all six Southeastern states, according to the U.S. Bureau of Economic Analysis (BEA) (see chart 3 on page 28). After years of fairly steady growth since 2004 (with the exception of the effects of Hurricane Katrina on Mississippi and Louisiana), real personal income growth plummeted, becoming negative in all Southeastern states (and led by Florida) by early 2008.

Florida and Georgia led the declines in real personal income growth. Income in Florida was, on average, 3.5 percent lower in the second quarter of 2009 than in the same period in 2008, according to the BEA. Income in Georgia fell 3.2 percent

Chart 1  
Top Southeast Export Crops



Note: Data are for 2008.  
Source: U.S. Department of Agriculture

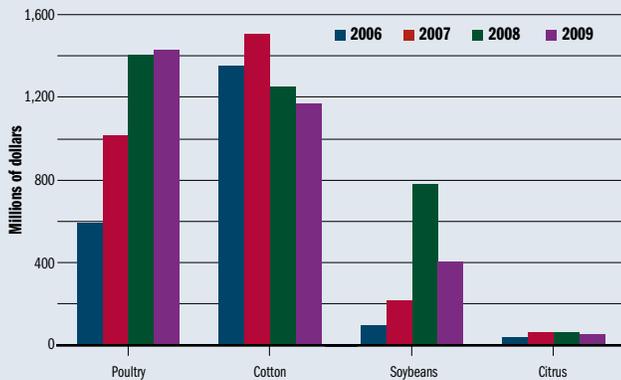
\$1.6 billion in cash receipts, a 12 percent decline from a year earlier, according to the USDA. About three quarters of the region's cotton production is shipped to some of the world's largest textile producers in China, Turkey, Mexico, Vietnam, Pakistan, and Bangladesh.

During 2009, net cotton exports were down from 2008 and 2007 levels. Soft global demand and lower prices have induced farmers to shift cotton acreage to other, more lucrative crops. However, the USDA believes global market conditions for 2010 are more favorable for U.S. cotton exports because of decreasing global stocks and tight markets.

in the second quarter of 2009 compared with a year ago. Consumers in Georgia and Florida have experienced six and seven consecutive quarters of negative growth, respectively. States in the Southeast haven't seen levels of real personal income growth this low since the early 1980s.

The ARRA attempted to reverse this slide and boost income by providing states with transfers in the form of tax cuts and rebates, higher earned-income tax credits, and funding for expenses including unemployment and health care, to name a few. Wage growth was already declining among Southeastern states, but without the

Chart 2  
Export Values of Selected Southeastern Agricultural Products



Note: Data are for January through August of each year.  
Sources: U.S. Department of Commerce, U.S. Census Bureau

### Global appetite for soybeans grows

Soybeans are another increasingly important crop. In 2008, soybean exports increased sharply, surpassing citrus as the third-largest export industry thanks to strong global demand. This growing demand has increased revenue potential, resulting in farmers shifting land toward greater soybean production.

Clearly, strong domestic and world markets supported soybeans' recent steady price trends. For example, between 2007 and 2009 soybean prices jumped from \$6 to about \$10 per bushel. China is by far the largest and fastest-growing export market for soybeans, followed by Mexico, Japan, and other Asian

countries. Alabama, Georgia, Louisiana, Mississippi, and Tennessee were major regional soy producers in 2008. The USDA projects strong demand will likely support steady growth of soybean exports in 2010.

### Citrus industry squeezed

Florida's citrus industry has a \$9 billion annual economic impact on the state's economy. Production is concentrated in several mid- and south Florida counties that account for about 25 percent of the nation's citrus crop. Florida is the nation's leading orange-producing state, and its production is currently only surpassed by China and Brazil worldwide.

In 2008, Florida's citrus crop, including oranges, grapefruit, and tangerines, generated \$1.6 billion in cash receipts, up slightly from a year earlier, according to the USDA. Exports in 2008 accounted for about half of Florida's citrus revenues and were about 10 percent higher than in 2007.

Citrus producers in 2009 battled citrus canker and greening diseases that reduced production and raised operating costs. Because of a smaller citrus crop this year, global sales were also down, reducing citrus' trade surplus in 2009 to \$54 million, 14 percent lower than in 2008.

For 2010, the outlook for citrus is mixed. Recent estimates of a smaller citrus crop resulted in an uptick in futures prices in September 2009. If sustained into 2010, higher prices should help compensate for the high costs of ongoing battles with plant diseases. ■

ARRA levels might have been significantly lower, as shown by the difference between personal income and personal income minus transfer payments. For example, in July 2009, real and personal income fell by 1.59 percent in the United States, according to the BEA. Without the ARRA-created transfer payments, real personal income that month would have declined 4.47 percent, the BEA said.

### Encouragement appears on store shelves in late 2009

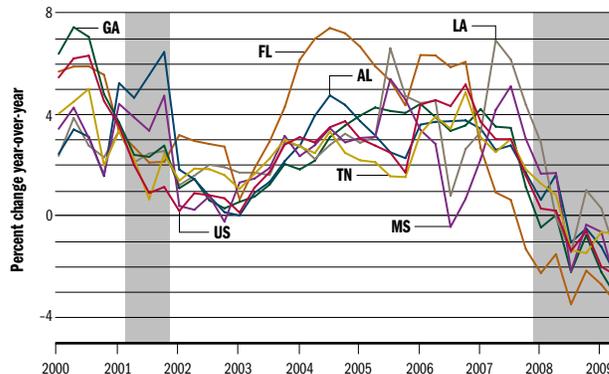
Southeastern retailers didn't have a lot to feel good about in 2009 as declining sales, traffic, and prices offered little hope for

improvement. In September, however, national retail sales (excluding autos) were stronger than anticipated, and this performance mirrored reports from regional retailers. In the Atlanta Fed's latest informal survey of Southeastern retailers, conducted in November 2009, retailers reported that sales and traffic had increased from year-ago levels and prices were stabilizing. They were happy with inventory levels and more optimistic about the coming months.

The majority of retailers who participated in the retail survey reported November sales were at or above what they



Chart 3  
Real Personal Income Growth, 2000-09



Note: Data are through the second quarter of 2009. Gray bars indicate recession  
Source: U.S. Bureau of Economic Analysis

The majority of retailers reported no change from last year's inventory levels, and 100 percent of respondents were satisfied with their current levels. This response may reflect more optimism among regional retailers, who had been keeping inventories as lean as possible at just-in-time levels.

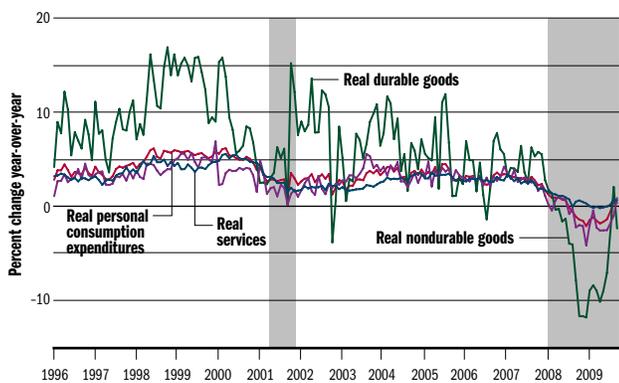
### Looking ahead to 2010

The U.S. economy is largely based on consumer spending: More than 70 percent of the gross domestic product is made up of personal consumption expenditure. A return to prerecessionary growth levels soon will depend on consumers having confidence to loosen their purse strings.

Holiday sales expectations for 2009 are fairly mixed throughout the Southeast, with retailers overall anticipating flat sales compared with last year. But regional retailers had similarly poor expectations for back-to-school merchandise, and those sales were stronger than anticipated.

Although consumer wealth, wages, and employment remain weak, retail sales strengthened toward the end of 2009, which perhaps indicates that consumers might be willing to spend more in 2010. Overall, however, weak household incomes are constraining consumers.

Chart 2  
Real Personal Consumption Expenditures



Note: Data are through August 2009. Gray bars indicate recession.  
Source: U.S. Bureau of Economic Analysis

expected, with 54 percent reporting activity as "above plan" in November compared with only 6 percent during the summer. Although 50 percent of respondents reported low traffic levels, this figure is down from 69 percent in August. And while only 16 percent of retailers reported higher levels of activity from a year ago in August, that share jumped to 39 percent in September.

# Employment Gets Worked Over



After a year of job losses in 2008, Southeastern states—much like the nation—shed additional jobs in 2009. Similar to national trends, the large-scale employment losses that occurred in the fourth quarter of 2008 in the Southeast persisted into the first quarter of 2009. Collectively, the region lost about 300,000 jobs in the first quarter of 2009. Subsequently, regional job losses decelerated, but employment levels remained low with limited signs of future growth.

## Job losses persist in 2009

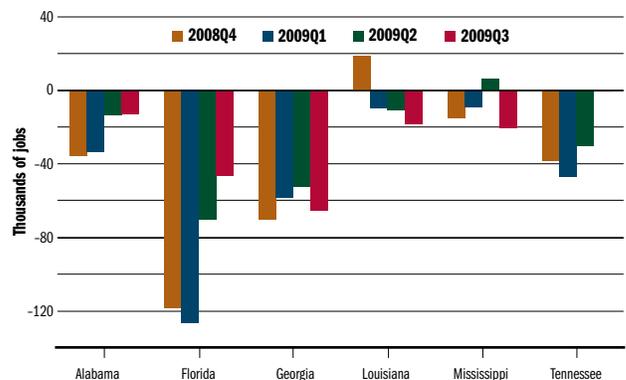
Collectively, Southeastern states lost 1.3 million jobs from the start of the recession in December 2007 through the third quarter of 2009; half of those jobs were shed in 2009. Thousands of firms reduced their work forces while others shut down completely. By the end of 2009, unemployment was at its highest level since the 1981–82 recession, according to the U.S. Department of Labor.

Florida and Georgia had the bulk of employment losses in the Southeast in 2009. However, Florida's job loss in the first three quarters of 2009 was lower than the number of jobs lost in the first three quarters of 2008. Compared with Georgia,

**Despite some recent improvements in the economy and easing of job losses, Southeastern labor markets are far from recovered.**

37 percent of Florida's recession-related job losses occurred in the first three quarters of 2009; Georgia incurred more than half of its job losses during the same period. This differential can be attributed to Florida's position on the leading edge of job losses, especially in construction, when the recession was just starting.

Chart 1  
Quarterly Job Loss by State



Sources: U.S. Bureau of Labor Statistics and the Federal Reserve Bank of Atlanta

Despite the slowing job losses in Florida's key industries such as construction and leisure and hospitality, the state remained the largest contributor of job losses in the Southeast with 227,000 through the third quarter of 2009. This loss was the third largest in the nation after only California and Texas.

All major industries lost jobs—not only in Florida but across the Southeast (see chart 1). Georgia shed more than 160,000 jobs through the third quarter of 2009, according to the U.S. Department of Labor, and lost more than 30,000 jobs in each of the state's construction, manufacturing, and trade and transportation sectors. Employment in Georgia's government sector was one of the weakest in terms of job loss in the Southeast in 2009, Department of Labor data show.

All of the region's industries except education and health care lost jobs. In the first three quarters of 2009, Tennessee and Alabama lost roughly 80,000 and 55,000 jobs, respectively, while Mississippi shed about 20,000 jobs. Employment declined 6 percent in Alabama's manufacturing sector, which was roughly

14 percent of total employment in the state in 2008 compared with 10 percent for the nation. Although the Midwest bore the brunt of auto plant closings, auto part suppliers in the Southeast also suffered: Alabama lost 2,000 auto supplier jobs in 2009 through September, according to U.S. Department of Labor data.

### Louisiana joins the job loss mix

While the rest of the Southeast shed jobs throughout 2008, Louisiana gained 12,000 net jobs, partly supported by high energy prices and ongoing post-Hurricane Katrina rebuilding. However, energy prices began to decline toward the end of 2008 and remained low in 2009. Moreover, the Atlanta Fed's business contacts in Louisiana noted that post-Katrina rebuilding, which buttressed Louisiana's economy for much of 2008, was on the wane.

After a rapid increase since October 2005, employment growth slowed in 2007 and 2008 and began to decline in 2009. Year-over-year employment growth turned negative in April 2009, and the state shed roughly 40,000 jobs through the third quarter of the year. Industries such as natural resources, mining, construction, and trade and transportation, which saw employment gains in 2008, posted declines in 2009.

Although Louisiana is one of only two states in the Southeast with an unemployment rate below the national average, its 7.4 percent unemployment rate in October 2009 was the highest there since 1994, excluding the period affected by Hurricane Katrina.

As of October 2009, the Southeast's 10.4 percent unemployment rate was well above the national average and the highest since 1983.

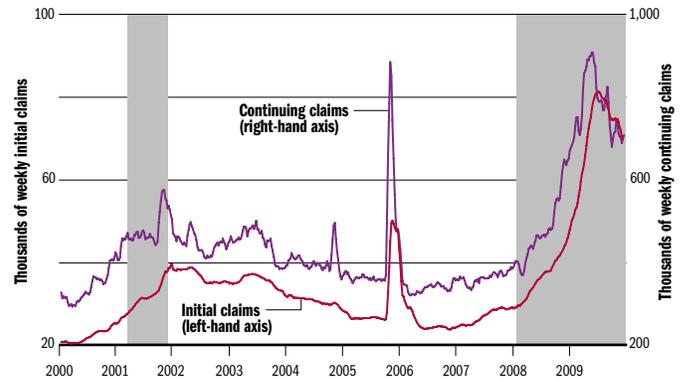
### A few bright yet isolated spots

Job losses eased in parts of the Southeast compared with the fourth quarter of 2008 and the first quarter of 2009. The region lost roughly 100,000 fewer jobs in the second quarter compared



Chart 2

### Southeast Initial and Continuing Unemployment Claims



Note: Data represent a four-week moving average and are through Oct. 10, 2009. Gray bars indicate recessions. Sources: U.S. Department of Labor and the Federal Reserve Bank of Atlanta

with the first quarter. In particular, year-over-year employment declines in Florida's construction sector appeared to bottom out in spring 2009. Likewise, year-over-year employment declines in Alabama's manufacturing sector began to show signs of bottoming out in June 2009.

Furthermore, American Recovery and Reinvestment Act (ARRA) funding is still reaching local governments and affecting employment, according to recovery.org, which tracks federal stimulus spending. Through October 2009, the ARRA has created or saved more than 20,000 jobs each in Florida and Georgia, according to recovery.gov. Similarly, more than 9,000 jobs have been created or saved in Louisiana and Tennessee, and ARRA has created or saved more than 3,000 jobs each in Alabama and Mississippi.

Despite these improvements, labor markets across the Southeast still struggled in 2009. Georgia's pace of job loss did not decline significantly through the third quarter of this year. Some sectors, such as Florida's financial sector, Georgia's government sector, and Alabama's transportation sector did not see notable improvements.

But job losses are only part of the burden on households: Workers have accepted hour and wage cuts while others have left the labor force entirely, discouraged by their job prospects. Year-over-year growth in labor force participation in the Southeast turned negative in May 2009 for the first time since the state-level series' inception in 1977 and was down roughly 2 percent through the third quarter.

Continuing unemployment insurance claims eased in the Southeast from the claims' high point in April 2009 (see chart 2), but the portion of this decline attributable to lower initial claims, exhausted benefits, or new hiring is unclear. For example, in the third quarter of 2009, roughly 70 percent of people who had claimed unemployment insurance in Florida for six months exhausted

their regular benefits and are no longer included in continuing claims figures. Hiring remained stagnant across the region through the third quarter of 2009, according to the Atlanta Fed's business contacts.

### Looking ahead to 2010

The decline in initial unemployment claims suggests that job losses will continue to ease into the next year. In 2008, when employment losses accelerated, the big question was when would job losses subside. In 2009, as job losses eased in parts of the Southeast and the nation as a whole, the question turned to when would employment expand and labor markets recover.

Two factors will support employment growth in 2010. As of Oct. 31, 2009, Southeastern states received less than 35 percent of the federal stimulus funds they were awarded, and this funding should continue to fortify the jobs picture in 2010. Additionally, after four quarters of contraction, the U.S. economy expanded in the third quarter of 2009, which should encourage hiring.

On the other hand, a number of factors could dampen employment recovery. Before hiring, firms will likely rely on current workers for increased productivity. Several Atlanta Fed regional business contacts across the Southeast have indicated that they want to see a few months of sustained growth before they consider increasing hours for current workers or recalling laid-off workers. Employers will require even longer sustained growth before they hire new workers.

Once firms begin to hire, the rate of hiring may be weak compared with previous expansions. Some business contacts indicated that they have not only reduced their work forces but have structurally changed their firms so they might need fewer workers in the future. Furthermore, the large number of firms closing across the Southeast produced permanent layoffs. For example, the region's auto parts manufacturers will continue to feel the pinch from auto plant closings. Despite some recent improvements in the economy and easing of job losses, Southeastern labor markets are far from recovered.

## States Confront Daunting Fiscal Challenges



**T**he recession hit Southeastern state government finances hard with dramatic declines in revenue. The reason is straightforward: The economic downturn has been deep in the region, and the falloff in economic activity has led to unprecedented declines in state tax collections. All states in the region have responded by reducing spending, cutting services, and shrinking government payrolls. Direct federal assistance to state governments through the American Recovery and Reinvestment Act of 2009 (ARRA) helped mitigate revenue shortfalls, but pressure on budgets remains significant. The prevalence of this pressure will be an important component of the outlook for 2010 and beyond.

### Gauging the downturn and its impact on state finances

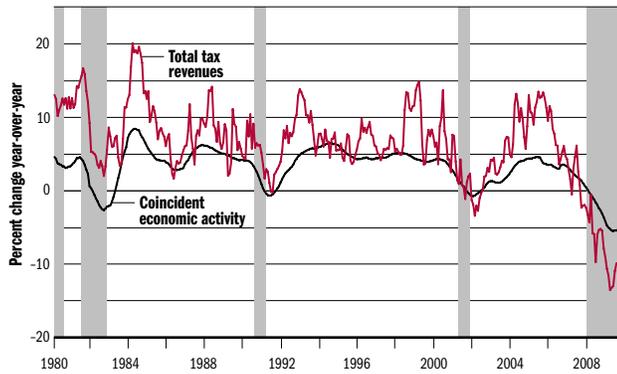
Since state-level gross domestic product (GDP) data are only available on an annual basis, more frequently available data are

useful to track economic activity more closely. The Federal Reserve Bank of Philadelphia produces a monthly index for all 50 states, and it combines four state-level indicators to summarize current economic conditions in a single statistic. The four state-level variables in each index are nonfarm payroll employment, average hours worked in manufacturing, the unemployment rate, and wage and salary disbursements adjusted for the U.S. city average of the consumer price index.

Chart 1 shows the year-over-year percentage change in this index and total tax revenues for Southeastern states. The current downturn represents the deepest decline for both measures as far back as the series goes, to 1980. The chart also reveals the relationship between economic activity and tax revenues and how recessions severely affect both factors.

In April 2009, the year-over-year percentage change in tax revenues for the region took its steepest fall, down 13.7 percent,

Chart 1  
**Coincident Economic Activity Indicator and  
 Total Tax Revenues for Southeastern States**



Note: Gray bars indicate recession. Data are through September 2009.  
 Sources: Federal Reserve Banks of Atlanta and Philadelphia, state departments of revenue

before declining 10.2 percent in September, according to the Philadelphia Fed's index. Prior to 2009, the deepest year-over-year decline since the early 1970s was 3.5 percent, reached in March 2002.

All individual states experienced significant downturns in total revenues. Based on revenues, each state is at or near record lows. While these measures are up from their recent troughs, they remain well below year-ago levels.

More locally, city and county governments have not been immune to the downturn in economic activity. Nationally, local tax revenue declined 2.8 percent in the second quarter of 2009 compared with the previous year, according to the Nelson A. Rockefeller Institute of Government—the first such decline since 2003. The revenue slowdown at the local level is less severe than at the state level because most local governments rely heavily on property taxes, which in many cases were not adjusted downward to reflect declining property values.

#### Southeastern States' Budgets Gaps for Fiscal Year 2010

	Total budget shortfall (billions)	Total shortfall as percentage of general budget
Alabama	\$1.2	16.7
Florida	\$6	23.3
Georgia	\$4.3	24.9
Louisiana	\$1.8	21.6
Mississippi	\$0.655	13.2
Tennessee	\$1	9.7

Source: Center on Budget Policy and Priorities

#### State budgets feel the pinch

States vary their spending during the business cycle. When economic activity is robust and tax revenues strong, states tend to spend a greater share of their revenue on services and programs such as education and transportation projects. During economic downturns, states tend to spend a greater share of their revenue on social welfare programs. However, limited revenues constrain all spending. State budget shortfalls have been significant regionally (see the table).

States responded to revenue shortfalls by cutting spending and services. For example, four Southeastern states enacted cuts in Medicaid or children's health insurance programs—Florida, Georgia, Louisiana, and Tennessee, according to The Center on Budget and Policy Priorities (CBPP), a policy center studying federal and state roles in fiscal policy and public programs that affect low- and moderate-income families and individuals.

The CBPP also reported that several states cut their education budgets, including those for K–12 and higher education, and reduced their employment rolls. In addition, state government employment has also been curtailed. For example, Georgia imposed furloughs, pay cuts, or both for some state employees. In Tennessee, the governor announced elimination of more than 2,000 state positions, about 5 percent of the state government work force. Alabama, Florida, and Georgia also ordered hiring freezes.

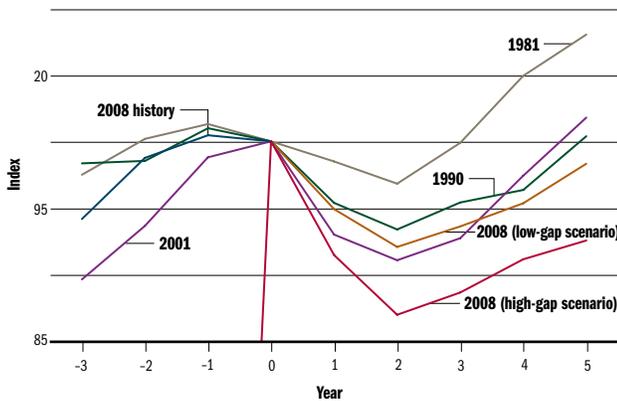
#### ARRA to the rescue?

Christina Romer, chair of President Obama's Council of Economic Advisors, testified before Congress in October that \$43.8 billion in federal stimulus went to state fiscal relief. The majority of these funds was applied to Medicaid and education shortfalls, according to an informal September survey of Southeastern state budget officials conducted by the Atlanta Fed. But budget gaps persist in Southeastern states in part because not all of the promised stimulus money has arrived yet. Even with the anticipated stimulus help, most states would still experience budget gaps. While states report that the ARRA stimulus mitigates their fiscal stress, it has not completely bridged—and most likely will not bridge—budget gaps.

#### Looking ahead to 2010

Many economists believe the national recession likely ended during summer 2009, and state-level improvements are also apparent. All Southeastern states except Alabama had monthly decreases in their economic activity in September that were smaller than those experienced in August, the Philadelphia Fed's index of economic activity showed. For the states that continued to experience month-to-month declines, the rate of the deterioration was much slower than earlier in 2009. Unfortunately for states' budgets, the emerging recovery will not result in immediate relief.

Chart 2  
**Tax Revenue Recovery Following Recessions**



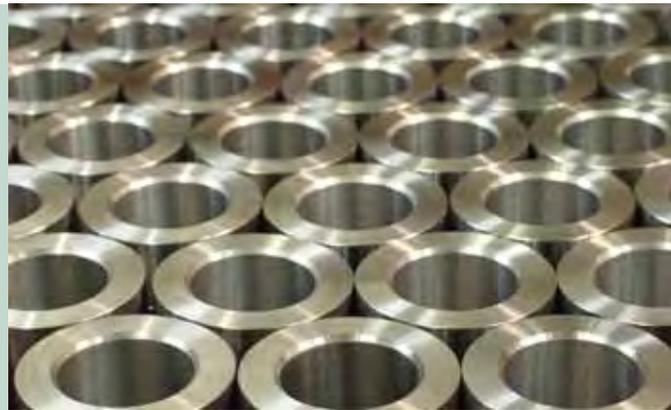
Note: Data represent tax revenues adjusted for population growth, inflation, and legislative changes and are indexed to 100 at the start of each fiscal crisis (year 0).  
 Source: The Nelson A. Rockefeller Institute of Government

The Rockefeller Institute estimated in September that it takes at least three to five years after the onset of serious revenue declines before states regain their precrisis revenue levels (see chart 2).

Rebounds in employment and wages are particularly important to state fiscal fortunes. The CBPP estimates that Southeastern states will register budget gaps of at least 10 percent in the current fiscal year.

State government finances are under pressure from declining revenues. The downturn in economic activity led to declines in state sales tax intake and drops in other revenue sources. Budget cuts were enacted, and the relief from federal stimulus funds did not fully mitigate the budget shortfalls. As a result, pressure on state budgets remains significant. Even though the economy is growing again, state finances are likely to remain challenged over the next several years.

## Southeastern Manufacturing Still Down, but Not Out



**S**outheastern manufacturing in 2009 shook off a few body blows but hasn't yet recovered its fighting trim. Many manufacturing firms closed their doors or scaled back operations because the recession hit big-ticket items especially hard. In particular, durable goods producers—especially auto-makers—have suffered. Manufacturing in the Southeast is still contracting, but at a significantly slower pace than last year, according to Kennesaw State University's (KSU) Purchasing Managers Index (PMI) in October.

### The PMI hits bottom

KSU's PMI measures new orders, production, employment, inventories, and pricing for manufacturing firms in the South-

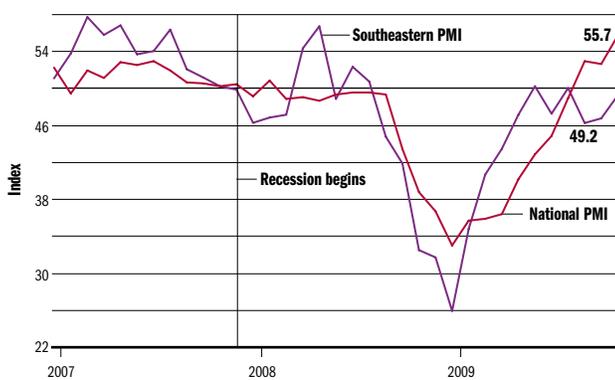
east. Index readings above 50 indicate expansion while readings below 50 indicate contraction (see chart 1 on page 34). For the first seven months of 2009, the Southeastern PMI fared better than the national index. However, since August, the national index outperformed the Southeastern index.

Manufacturing index readings hit historical lows in 2008; the Southeastern PMI bottomed out at 25.8 in November 2008 and didn't reach 50 again until May 2009, when it hit 50.2. October saw another gain, though it's not certain if the region's manufacturing has turned the corner.

While the overall PMI has been sluggish, Southeastern manufacturers regarded certain components of the index with heightened optimism. New orders and production surged from

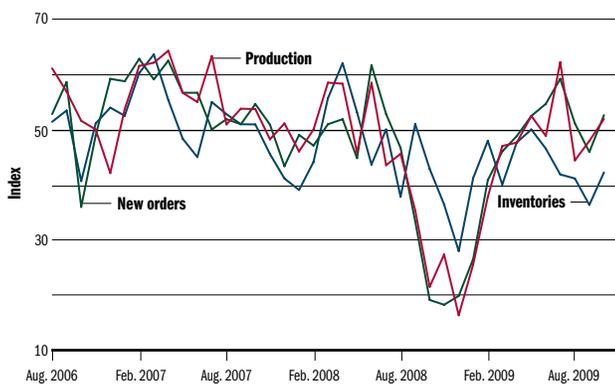


Chart 1  
National and Southeastern PMI



Notes: Data are through October 2009. A reading higher than 50 indicates expansion; lower than 50, contraction.  
Source: Kennesaw State University's Institute for Supply Management

Chart 2  
Southeastern PMI Components, 2006-09



Note: Data are through October 2009.  
Source: Kennesaw State University's Institute for Supply Management

May to July, with the production component reaching 62.2 in July (see chart 2). The new orders component also peaked in July with a reading of 59.2. These component readings reflected national trends with the “cash for clunkers” program greatly, but only temporarily, improving demand for automobiles and auto-related manufacturing.

Also, consistent with national trends, manufacturing inventories in the Southeast continued to diminish, reaching the 50-point benchmark only once, in May 2009. (Inventory index readings above 50 indicate expansion while readings below 50 indicate contracting inventories.) Since then, inventories shrank at accelerating rates until October, when the index indicated a slightly slower pace of decline than the previous month. Many Atlanta Fed regional contacts said the recession's weak consumer demand led them to pare inventory to bare-bones levels or to move it into warehouses since warehouse space is cheaper than retail floor space.

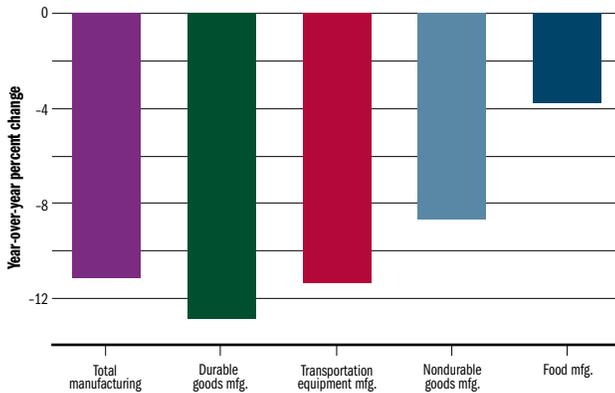
The Southeastern PMI summarizes the last three years of economic activity: For 2007, the annual average showed expansion at 53.1. The regional average in 2008 was a pallid 44.4 and reflected the broader economic slowdown. Through October, 2009's regional index was higher and hinted that the year may average an expansion.

### Manufacturing employment hit hard

Examining employment allows an effective evaluation of the region's manufacturing activity, and the evaluation in the Southeast is mixed at best. From 2007 to 2008, the region lost 5.1 percent of its manufacturing employees. From the third quarter of 2008 through the third quarter of 2009, job losses accelerated, posting an 11.2 percent decline during the period (see chart 3).

Though both durables and nondurables manufacturing employment suffered losses in 2009, employment declines in durable goods (those lasting three years or longer) were more dramatic—down 12.9 percent in the region from the third quarter of 2008 to the third quarter of 2009 compared with a loss

Chart 3  
**Employment Changes in the Southeast, 2008Q3 Versus 2009Q3**



Notes: Data are for the third quarter of 2008 compared with the third quarter of 2009.  
 Source: U.S. Bureau of Labor Statistics

of 5.8 percent between the third quarter of 2007 and the third quarter of 2008. Manufacturers of nondurable goods—those lasting less than three years—shed 8.7 percent of their jobs over the same time period compared with a 4.2 percent loss from 2007 to 2008.

But if there was one component of the Southeast’s manufacturing sector that experienced a year of ups and downs, it was transportation equipment, including motor vehicle production.

Just when Ford Motors’s 2006 shuttering of its Hapeville, Ga., assembly plant was becoming a dim memory, reminders of automaking’s woes continued. Truck manufacturer Paccar Inc. idled its Peterbilt plant in Madison, Tenn., in June 2008, and General Motors closed its Doraville, Ga., assembly plant in

## If there was one component of the Southeast’s manufacturing sector that experienced a year of ups and downs, it was transportation equipment.

September 2008 and idled its Saturn plant in Spring Hill, Tenn., in June 2009. All told, 3.9 percent of U.S. employees in transportation equipment lost their jobs in 2008, according to the U.S. Bureau of Labor Statistics, almost tripling to 10.6 percent during the first three quarters of 2009.

Some employers avoided layoffs by efforts such as implementing 30-hour work weeks. Some instituted a one-week furlough each month, which allowed employees to collect

unemployment for their furloughed hours in states offering that benefit. For employers, these measures are not entirely altruistic: They are concerned that skilled employees who are laid off might find work elsewhere when the firm once again needs their skills.

### Looking ahead to 2010

But the news is not all dire. Several large capital investment manufacturing projects are scheduled for completion in 2010. Foreign automakers are investing heavily in the region, and the economic ripple effects will be felt for years to come. For instance, Volkswagen is opening a \$1 billion facility in Chattanooga, Tenn., in late 2010 or early 2011 and plans to employ 2,000 workers. Parts suppliers for the new plant will create more than 11,000 jobs, according to a University of Tennessee study. Kia Motors also opened its West Point, Ga., plant in the third quarter of 2009 to manufacture its Sorento model, a move that will bring 1,200 jobs to the area and have economic effects felt fully in 2010.

Manufacturers other than automakers are also putting down Southeastern roots. Mitsubishi’s Pooler, Ga., plant will add 500 jobs to the region in early 2010. The plant will produce advanced steam and gas turbines and will also service turbines used in power generation. GS Yuasa, a high-tech firm, is scheduled to open its doors, creating 100 jobs in Roswell, Ga., producing lithium-ion battery packs. NCR is already making ATMs in Columbus, Ga., and plans to employ 870 people during the next three years. Additionally, Huiheng Medical is opening a Baton Rouge, La., plant that will manufacture radiation treatment devices, creating 300 jobs in the area.

Overall, Atlanta Fed business contacts expect a slow, gradual recovery, which does not bode well for the typical, hoped-for V-shaped recovery in which the economy declines steadily during a recession but then improves just as steadily once expansion takes hold. They commonly cite persistently weak demand and concerns about credit and funding once production needs to ramp up again.

Nationally, industrial production is beginning to stabilize, and capacity utilization rates are again above 70 percent, according to Federal Reserve Board data. Industrial production was running at about 75 percent prior to the recession. Historically low inventory levels could prompt a restocking of shelves, and a recovering global market with a weaker dollar could be good news for U.S. exports in 2010. While some contacts are reporting an upbeat outlook for the next year, they add that a significant and sustainable recovery will have to precede efforts to boost capacity and rehire workers.

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# Tourism Hits Choppy Waters



**T**ourism contributes significantly to the Southeast's economy, so based on recent economic developments, it should come as no surprise that the region felt it when the tourism sector took a significant hit in 2009. Income, consumer spending, employment, household wealth, and consumer confidence all fell markedly, making "stay-cationers" (people who took vacations near home), online discounts, last-minute travel specials, and package deals the new normal. Essentially, the tourism industry switched gears in 2009 from maximizing profits to just staying afloat and breaking even during the recession.

## Leisure and hospitality have idle time

Virtually every aspect of tourism took a hit in 2009. Even international travelers—usually a reliable source of tourists and revenue—were less likely to visit the United States in 2009. International travel to the United States fell in the first three months of 2009 compared with the same period in 2008, the first annual decline since 2003, according to data from the U.S. Department of Commerce. On a monthly basis, international travel fell 21 percent in August, the 11th consecutive monthly decline. International travel to the United States reached a record high of 58 million travelers in 2008, but the number was expected to be around 53 million by the end of 2009, down 8 percent. Tourism-related revenue fell across the board in the Southeast as cruise ships' rooms were unoccupied and passengers spent less money while onboard, flights were not full, and more tables in mid-to-high-end restaurants sat empty.

Business in Florida restaurants, excluding fast-food restaurants, fell 20–30 percent in 2009 compared with 2008, according to Atlanta Fed business contacts. High-end restaurants throughout the region tried to attract customers by offering discounts such as two-for-one deals, an unprecedented phenomenon not seen before the economic downturn at that type of restaurant.

Atlanta's airport saw traffic fall 0.4 percent in August 2009 from August 2008. In fact, airport traffic there hovered below year-ago levels during all of 2009 (see chart 1 on the next page). In New Orleans, total outgoing flights and passengers were at their lowest levels since 2003, falling 37 percent and 34 percent, respectively, from 2008 levels.

A major cruise line reported onboard spending fell 10 percent from last year, and revenue and average ticket prices declined 15 percent.

In Alabama, the overall travel sector was down about 7 percent from 2008. The state's beaches remained the top tourist attraction and helped keep the state's tourism industry afloat.

Attendance at Florida's Universal Studios Orlando theme park was down 11 percent during the third quarter of 2009 compared with the third quarter of 2008, company data show. Attendance at the theme park from January to September was down more than 14 percent, and net income was down 21 percent from the same period last year.

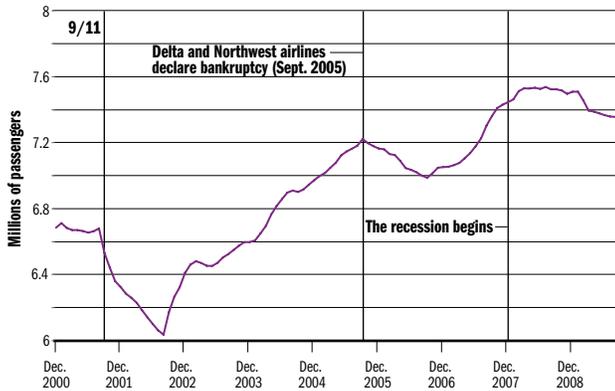
Even casinos felt the slump. Gaming tax revenues in Mississippi in October 2009 were 10 percent lower than during the same period in 2008 (see chart 2 on the next page). Gaming is an important source of tax revenues for Mississippi, and gaming's decline there is a result of fewer casino visitors.

Despite the bad news, industry observers feel that tourism has reached its bottom and that the industry is poised to rebound.

## Hotels flash vacancy signs

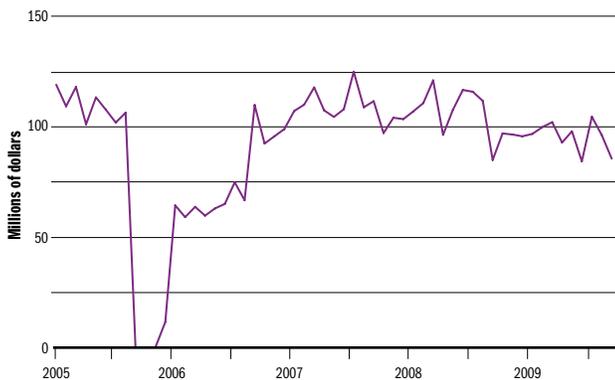
Business-related travel and convention attendance declined significantly in 2009, according to Atlanta Fed contacts, taking a toll on hotel reservations. Room rates fell as aggressive discounting and guests' restrained spending ate into margins. In Atlanta, a major convention city, demand for hotel rooms and room revenue decreased more than 11 percent in 2009 over 2008 levels, according to Atlanta Fed business contacts.

Chart 1  
**Airline Passenger Traffic,  
 Hartsfield-Jackson Atlanta International Airport**



Note: Data are through August 2009.  
 Source: Economy.com

Chart 2  
**Mississippi Gaming Tax Revenue**



Note: Data are through September.  
 Source: Mississippi Tax Commission

These circumstances combined to lead many tourism companies to trim staffing levels.

But in New Orleans, hotel bookings for conventions were a bright spot for the city during 2009. Meeting-related hotel occupancy rose 6 percent in 2009 from 2008 levels, based on prebookings and reservations, according to the New Orleans Metropolitan Convention and Visitors Bureau.

Cruise line occupancy rates remained relatively solid in 2009, with the exception of routes to Mexico. However, the high occupancy rates were the result of significant discounting and thus diminished revenue. The H1N1 pandemic dissuaded many travelers from booking spring and summer cruises as well as flights from the United States to Mexico.

### New Orleans manages to let the good times roll

New Orleans had strong attendance at its annual festivals during 2009, according to data from the University of New Orleans. The year's major events all had higher attendance than the previous year. The French Quarter Fest had 441,000 attendants, up 6,000 over 2008. Attendance at the Jazz Heritage Festival rose by 25,000, to more than 400,000. The Essence Fest attracted 428,000 visitors, up from 270,000 in 2008. And the granddaddy of the city's events—Mardi Gras—had 825,000 attendees compared with 725,000 in 2008.

Since the number of outgoing flights and passengers through the Louis Armstrong New Orleans International Airport was down in 2009, most of these festival-goers were likely from within the state or within driving distance.

### Looking ahead to 2010

While tourism continued to decline in the Southeast late into 2009, many Atlanta Fed regional contacts report that activity nevertheless surpassed their low expectations, leading to some mild expressions of near-term optimism. They anticipate that tourism will slowly pick up throughout 2010 and 2011. For example, Miami is hosting the Orange Bowl, Pro Bowl, Super Bowl, and a large boat show in 2010, which should attract visitors from throughout the nation and boost tourism revenue in south Florida.

Conventioneers are making airline and hotel reservations well into 2010 and 2011; these bookings are at levels that surpass 2009's prebookings. In Atlanta, convention bookings are up 20 percent for 2010 compared with 2009, according to Atlanta Fed business contacts, a performance consistent with the U.S. Department of Commerce's forecast for the nation.

International travel to the United States is expected to increase by 3 percent in 2010 over the previous year, and industry observers anticipate annual increases of 5 percent through 2013. The number of tourists from Canada and Mexico (traditionally the source of most tourists to the United States) are expected to decline by 6 and 12 percent, respectively, by the end of 2009 compared with 2008, but the total number of travelers from Canada and Mexico to the United States is expected to increase by 13 and 5 percent, respectively, from 2008 to 2013. These anticipated increases provide a glimmer of optimism for the tourism industry, which hopes that the current anemic spending on travel and tourism is a temporary symptom of current economic conditions rather than a permanent change in tourist behavior. ■

*Mark Carter, Michael Chriszt, Courtney Nosal, Julie Hotchkiss, Whitney Mancuso, Menbere Shiferaw, and Gustavo Uceda of the Atlanta Fed's research department contributed to this article.*

continued from page 1

of bank loans to small businesses would pose problems for the economic recovery. One potential source of such a shock is commercial real estate (CRE).

### **CRE's problems cascade**

The challenges to CRE are substantial. The total volume of commercial mortgages held by banks more than tripled in the last decade nationally, peaking at approximately \$1.8 trillion in 2008. The most significant growth occurred in construction and development loans, which are used to acquire land and build new commercial structures. But with demand for new development very low, construction has slowed significantly. At the same time, existing buildings are having trouble finding tenants. As a result, the income generated by commercial properties has been falling, which has put downward pressure on property values.

With more than \$300 billion in CRE loans estimated to need refinancing in 2010 and 2011, declining property valuations are particularly problematic for CRE borrowers and lenders alike. For borrowers, there is potentially greater difficulty renewing the loan based on lower collateral valuations. For lenders, borrowers have an increased risk of defaulting on the loan. Indeed, delinquency rates on CRE loans increased sharply in 2009, especially for construction and development loans, resulting in increased loan losses for banks.

Importantly, unlike the residential mortgage market, where a majority of lending has been done by a few large banks, the array of banks holding large concentrations of CRE loans is broad. Indeed, based on call report data for June 2009, smaller banks (those with total assets under \$10 billion) hold almost half of all the CRE loans even though they account for only 20 percent of total bank assets in the United States.

I have discussed CRE in some detail to ask a question relevant to small business: Are the types of banks that have relatively high CRE exposure also an

important source of credit to small businesses? As it turns out, the banks with high CRE exposure (those with a CRE loan book that is more than three times their tier 1 capital) accounted for about 40 percent of all commercial and industrial (C&I) loans to small businesses as of June 2009. To put this in context, a decade earlier banks with high CRE exposure accounted for about 20 percent of small business C&I loans.

While it is reasonable to assume that the banks concerned about a high exposure to CRE are likely to take a conservative approach toward lending generally, this assumption does not automatically imply that small businesses will be unable to get bank funding when needed. For instance, other less constrained banks may be able to step in to provide the needed financing. Indeed, some of the largest lenders and providers of credit to small businesses have relatively low CRE exposure.

Recognizing the importance of the CRE sector for the economic recovery, the Federal Reserve has extended its TALF programs for existing commercial mortgage-backed securities (CMBS) through March 2010 and newly structured CMBS through June. Moreover, the various banking supervisory agencies have encouraged banks to work with their creditworthy borrowers to restructure troubled CRE loans and reminded examiners that, in general, a loan should not be classified as impaired based solely on a decline in collateral value.

Small businesses today face a number of hurdles apart from access to credit—poor sales, for example. But small businesses' adequate access to funding is essential if they are going to play their traditional role as an engine of growth. How small business weathers its current challenges hinges in large part on a broader banking recovery. ■

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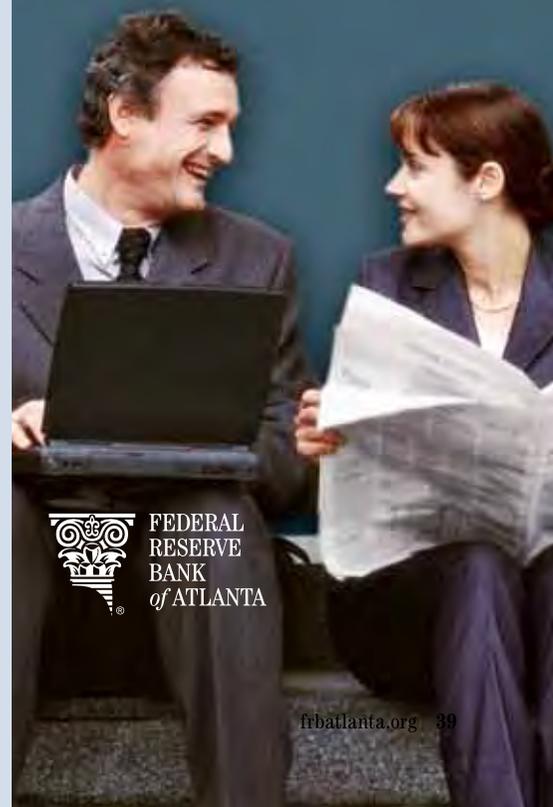
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# Closing the Gap

## 11.2

Percent decline in manufacturing employees in the Southeast from the third quarter of 2008 through the third quarter of 2009

Source: U.S. Bureau of Labor Statistics, as cited in *EconSouth's* article, "Southeastern Manufacturing Still Down, but Not Out"



## 55

Percent of unemployed U.S. workers who describe the separation from their jobs as permanent

Source: U.S. Bureau of Labor Statistics, as cited in *EconSouth's* article, "U.S. Economy Takes Steps Toward Recovery"

## 28

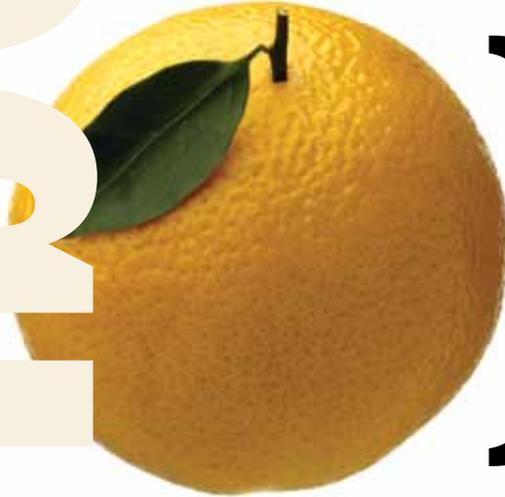
Percent decline of autos assembled in the Southeast in 2009 compared with 2008

Source: U.S. Bureau of Labor Statistics, as cited in *EconSouth's* article, "Auto Production Hits Bumps in Southeast"

## \$300

Amount, in billions, of commercial real estate loans estimated to need refinancing in 2010 and 2011

Source: Mortgage Bankers Association, as cited in *EconSouth's* article, "Small Businesses' Challenge"



## \$9

Amount, in billions, of the annual economic impact of Florida's citrus industry

Source: U.S. Department of Agriculture, as cited in *EconSouth's* article, "Exports Brighten the Region's Farm Outlook"

## 5

Average percent growth of U.S. gross domestic product in the year following a recession

Source: U.S. Census Bureau, as cited in *EconSouth's* article, "U.S. Economy Takes Steps Toward Recovery"

## \$787

Amount, in billions, of the American Recovering and Reinvestment Act

Source: *Recovery.gov*, as cited in *EconSouth's* article, "U.S. Economy Takes Steps Toward Recovery"



## 9

Percent growth of China's economy in the third quarter of 2009, in part because of improved domestic demand and a resulting increase in imported raw materials.

Source: International Monetary Fund, as cited in *EconSouth's* article, "Global Outlook Takes a Turn Toward Improvement"

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