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St. Cloud Area
Quarterly Business Report

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Key Sectors Pull Down Area Economy

Executive Summary
The area economy continues to encounter uneven sluggishness as several key sectors have experienced recent slower-than-normal seasonal gains in employment. While overall employment in the St. Cloud area is higher than it was in February, year-over-year numbers indicate area employment in May 2003 was below that which was observed one year ago. Key sectors that have experienced weaker than normal seasonal gains over the past three months include manufacturing, financial activities, wholesale trade, and educational and health services. Both government and manufacturing sectors experienced outright declines in employment over the past three months, although employment losses in the former sector were lower than occurred last year from February to May. Retail trade is about the only local sector that is performing close to historical averages. It should be noted, however, that seasonal employment gains in this sector are biased by last year's Fingerhut closing.

The recent path of area economic activity is similar to the performance of the national economy. Commentators continue to refer to a national "jobless recovery" that is influenced by productivity gains, historically low interest rates, and a lower value of the dollar. These conditions seem to have contributed to an uneven pattern of national economic activity. While some sectors appear to be experiencing recent growth, others are very sluggish. The same can be said for area firms. Many area businesses report stronger business activity over the most recent quarter. Unfortunately, local economic gains have not yet been strong enough to lift the area to a broad economic recovery. Just as with the national economy, however, things appear to be looking up for many area firms (and their employees). Conditions are now in place that should help stimulate economic activity over the next few months. Stimulus arising from continued low interest rates, recent tax cuts, growing consumer confidence, a weaker dollar, and improved financial market performance all promise to lift area employment by the end of 2003. While several key firms remain vulnerable to heightened domestic and global competition, it is our view that, absent an unpredictable adverse shock, the area economy will finally begin to experience a broad recovery by late fall.

St. Cloud continues to fare worse than virtually all neighboring metropolitan areas. Area employment declines of 2.2 percent over the year ending May 2003 once again make St. Cloud stand out as one of the most economically distressed areas in the North Central U.S. This is, of course, in stark contrast to the performance of the area economy in the late 1990s and early 2000s. During that period, St. Cloud was frequently cited as one of the strongest metropolitan area performers in the upper Midwest. Indeed, the most commonly cited concern of area businesses at that time was an inability to attract qualified workers at existing wages. Current economic performance is far weaker than this earlier period, although recent quantitative

Uneven sluggishness afflicts local economy

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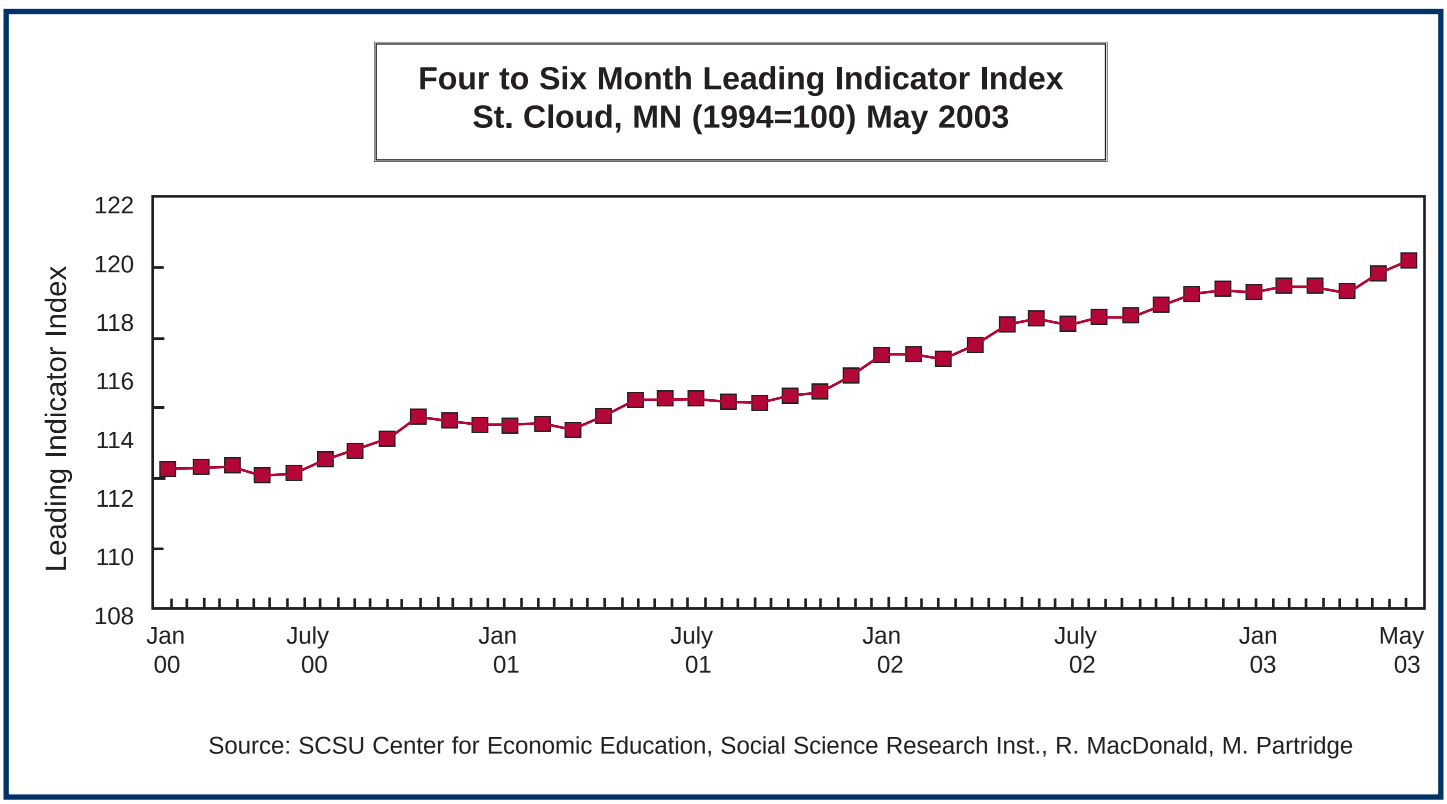
signs do point to emerging economic improvement over the next several months. After predicting no clear upturn over the past eighteen months, the **St. Cloud Index of Leading Economic Indicators** now projects enhanced economic activity by late fall. A sharp increase in the U.S. Index of Leading Economic Indicators along with steady improvements in the length of the local manufacturing workweek and in area residential electric hookups have caused a recent surge in the local index.

Sixty percent of the fifty-two firms responding to the **St. Cloud Area Business Outlook Survey** experienced an increase in business activity over the past three months. This is a sharp improvement over last quarter's survey, at which time only 28% of businesses had experienced increased activity. While some of this improvement results from gains in seasonal business, these increases point to the emerging economic recovery referenced above. The area labor market has not yet fully enjoyed recently improved business conditions. Only one out of every three surveyed employers indicates increased payrolls over the most recent quarter. This was partially offset by 19% of area businesses that cut back on workers. In addition, firms found it less difficult to attract qualified workers over the past three months. One bright spot for the area economy can be found in the 44% of surveyed firms that report an increase in capital expenditures over the past three months. Historically attractive interest rates, along with improved business optimism and a reduction in economic uncertainty appear to have had a highly favorable impact on local capital spending decisions. Going forward, 52% of area firms expect improved business conditions in six months' time versus fifteen percent that think activity will be slower. Although firms expect, on balance, to cut back on the length of the workweek and continue to anticipate having less difficulty hiring qualified workers by January 2004, there may be some relief on the horizon for area workers. Thirty-nine percent of surveyed firms expect to increase hiring in six months' time and only 14% anticipate a reduction in their work force.

Area labor market remains weak

A special question in the June 2003 **St. Cloud Area Business Outlook Survey** asked area business leaders about the extent to which they expected their company to experience an adverse impact from the possible establishment of up to 10 "Job Opportunity Building Zones" (JOBZ) in other parts of the state. Forty-six percent of responding firms indicate

Figure 1 — St. Cloud Index of Leading Economic Indicators (May 2003)



this would have "no effect" on their business and 31% thought this might have a "slight (adverse) effect". Only 15 percent of survey participants thought the effect would be either "moderate" or "substantial". It should be noted that none of the fifty-two firms participating in the survey indicate that they expected JOBZ to improve their business activity. A second special question asked area firms about the extent to which they are concerned about deflation. Only 27% of survey participants indicate they are "not concerned" about deflation while ten percent of firms note that they had not yet considered this issue. A surprisingly large thirty-five percent of area firms remarked that they are either "moderately concerned" or "extremely concerned" about the prospects of future deflation. In addition, 27% note a "slight concern" about deflation. Thus, 62% of surveyed firms indicate some level of concern about the potential prospects of a future deflation—-a development that we will follow in coming months.

St. Cloud Index of Leading Economic Indicators

After predicting no clear upturn in the last year-and-a-half, the May 2003 **St. Cloud Index of Leading Economic Indicators** finally projects that the St. Cloud area economy will begin to show some improvement in Fall 2003. The index is designed to forecast local economic activity four to six months in the future. Figure 1 shows that the index was essentially flat from mid 2002 through March 2003, but it sharply increased in April and May. While we normally would like to see at least three consecutive increases to formally predict a sustained economic upturn, the sharp increases in the last two months are encouraging. In May, the local index benefited from a sharp rise in the U.S. Index of Leading Economic Indicators and an increase in the average area production worker workweek, while steady increases in the number of local residential electric hookups have had a positive impact for the last several months. One small drag on the local index is the number of new local business start-ups as suggested by new registrants with the Minnesota Office of the Secretary of State. As a rule of thumb, three consecutive positive changes in the **St. Cloud Index of Leading Economic Indicators** suggest an expanding economy, while three consecutive decreases suggest a contracting economy and/or a slowing of economic growth.

Area economy should improve by late fall

The St. Cloud Area Overall Outlook

Table 1 shows non-farm employment data for the St. Cloud Metropolitan Area (MSA), Minneapolis-St. Paul (MSA), and Minnesota. This table reports different industry groupings using the North American Industrial Classification System (NAICS) (for more details, see the U.S. Department of Labor website http://www.bls.gov/bls/naics.htm). May 2003 St. Cloud MSA employment was 2.2 percent below that of May 2002. In the last year, St. Cloud job growth was almost 5 percentage points below its 1990-2003 long-term trend growth rate of 2.4 percent. While official monthly statistics only date to 1989, the recent job losses in the local economy are surely the most severe since at least the early 1980s. With the exception of strength in the local leisure & hospitality industry as well as the construction industry, Table 1 shows that declining employment is broad based across most sectors. Unfortunately, the local recession that began in late 2001 continued through the spring months of 2003. Going forward into latter 2003, we (still) expect to see improvements in the local employment picture compared to 2002, although much of this is simply because late 2002 was especially weak in the wake of the Fingerhut layoffs.

The area's 2.2 percent employment decline in the year ending May 2003 considerably lags the corresponding 0.4 percent decline in the state and the 0.3 percent decline in the nation. St. Cloud also trails the Duluth-Superior, Minneapolis-St. Paul, and Rochester MSAs (respectively, 0.5%, -0.7%, and -0.3%). Regarding other metropolitan areas near the Minnesota border (Grand Forks, Fargo-Moorhead, Sioux Falls, Sioux City, Des Moines, La Crosse, Eau Claire), only Sioux City and Des Moines experienced overall job losses in the year ending May 2003 (respectively -0.9%, -0.4%).

Most troublesome about the recent local economic performance is that the local labor market displayed particular weakness in the February to May quarter. During the 1992-2001 period, the local economy added an average of 2,915 jobs between February and May, reflecting the normal seasonal upturn in business activity. In the corresponding period in 2002, only 2,656 jobs were added, which can be entirely explained by layoffs at Fingerhut. However, in 2003, 1,970 jobs were added during the three-month period, or almost 1,000 fewer jobs than during the prosperous 1992-2001 period (note that we must caution that these employment figures from the state of Minnesota are preliminary and will be revised). At first glance, with no large local layoffs as in 2002, the weakness in 2003 is hard to explain.

Declining employment is broad based across most sectors

To gain a better understanding of the unexpectedly weak St. Cloud area labor market, the SCSU Center for Economic Education and the

Minnesota Economic Development Center conducted an extensive sector-by-sector analysis of local trends. The first clear finding is that the local retail sector is no longer the large drag it has been in recent years. While local retail employment in May was at the lowest level for the month of May since 1992, its employment had increased by 144 since February. The recent retail performance is on par with the average increase of 174 during the 1992-2001 period. Further suggesting a turn-around is that retail employment declined by 286 in 2002 between February and May.

By contrast, local manufacturers shed 58 employees between February and May, which compares unfavorably to the 275 increase in 2002 and the 345 average gain during this same period in the preceding ten years. Reflecting a recent tightening by healthcare providers, the increase in education and health services employment was 278 less in the 2003 February-May period than in 2002 and 181 below the 1992-2001 average. State government employment also fell by 584 jobs during the recent quarter, which is on par with the corresponding decline of 621 in 2002. By contrast, the average 1992-2001 decrease in state government employment from February to May was only 207. Indeed, state government employment fell by almost 15 percent between May 2001 and May 2003. More of the same is expected

Table 1 — Employment Trends

	St. Cloud Employment Trends in Percent			Minnesota Employment Trends in Percent			Twin Cities Employment Trends in Percent		
	1990-2003 Long Term Trend Growth Rate	May 02-03 Growth Rate	May 03 Employment Share	1990-2003 Long Term Trend Growth Rate	May 02-03 Growth Rate	May 03 Employment Share	1990-2003 Long Term Trend Growth Rate	May 02-03 Growth Rate	May 03 Employment Share
Total Nonagricultural	2.4%	-2.2%	100.0%	1.7%	-0.4%	100.0%	1.6%	-0.7%	100.0%
Total Private	2.7%	-2.1%	100.0%	1.8%	-0.5%	100.0%	1.6%	-0.6%	100.0%
GOODS PRODUCING	2.8%	-1.7%	22.4%	0.9%	-2.1%	18.0%	0.5%	-3.4%	16.5%
Construction/Nat. Res.	3.8%	2.7%	5.3%	3.3%	0.6%	5.0%	3.4%	-3.4%	4.6%
Manufacturing	2.5%	-3.0%	17.1%	0.2%	-3.1%	13.0%	-0.4%	-3.4%	11.9%
SERVICE PRODUCING	2.2%	-2.4%	77.6%	1.9%	-0.0%	82.0%	1.9%	-0.1%	83.5%
Trade/Transportation/Utilities	1.3%	-3.7%	22.0%	1.3%	-0.4%	19.8%	1.0%	-1.5%	19.3%
Wholesale Trade	2.8%	-2.1%	4.5%	1.5%	0.7%	4.9%	1.3%	-0.1%	4.9%
Retail Trade	0.9%	-4.8%	14.3%	1.3%	-0.3%	11.3%	1.2%	-0.4%	10.7%
Trans./Warehouse/Utilities	1.7%	-1.2%	3.2%	0.7%	-2.3%	3.6%	0.0%	-5.9%	3.7%
Information	3.1%	-0.9%	1.9%	1.7%	-0.7%	2.5%	1.7%	-3.2%	2.8%
Financial Activities	4.3%	-0.4%	4.2%	2.1%	-1.2%	6.3%	2.3%	1.2%	7.9%
Prof. & Business Service	3.9%	-4.2%	6.7%	2.4%	-1.4%	10.9%	2.1%	-1.7%	14.0%
Educational & Health	3.7%	-2.7%	15.3%	3.2%	2.7%	13.9%	3.1%	3.8%	12.2%
Leisure & Hospitality	2.7%	1.1%	8.8%	1.9%	0.4%	8.8%	2.1%	2.1%	9.0%
Other Services (Excl. Gvt)	2.5%	0.8%	4.7%	1.8%	-2.1%	4.4%	1.5%	-1.6%	4.2%
Government	0.7%	-2.8%	14.1%	1.2%	0.0%	15.4%	1.6%	-0.8%	14.1%
Federal Government	-1.1%	1.6%	1.6%	-1.0%	3.4%	1.3%	-0.7%	4.2%	1.3%
State Government	-2.1%	-12.5%	3.4%	0.1%	1.7%	3.3%	1.4%	2.0%	3.9%
Local Government	0.5%	0.5%	9.1%	1.9%	-0.8%	10.8%	2.5%	-2.7%	9.0%

Note: Long term trend growth rate is the compounded average employment growth rate in the specified period. St. Cloud and Twin Cities represent the St. Cloud and Minneapolis-St. Paul MSAs, respectively.
SOURCE: MN Workforce Center

during the current Minnesota biennium that began on July 1. It remains to be seen how state-aid cutbacks to local governments will affect area employment.

Another sector contributing to recent local weakness is financial activities (i.e., finance, insurance, and real estate). Specifically, during the February-May 2003 period, financial activity employment increased by only 8, which is 344 below 2002 and 71 below the corresponding 1992-2001 average. Finally, the February-May 2003 increase in wholesale trade employment was about 100 jobs below the corresponding figures for 2002 and the 1992-2001 average. In sum, unexpectedly severe weakness in local manufacturing, education and health services, state government, financial activities, and wholesale trade more than offset the recent upturn in the local retail sector to produce a rather dismal labor-market picture during Spring 2003.

There are reasons to believe that recent poor labor market conditions are concealing favorable trends that will begin to lift the local economy out of the doldrums. Foremost, the **St. Cloud Area Quarterly Business Survey** indicates that local businesses just experienced a reasonable quarter in terms of sales, but that local firms were reluctant to add new employees. This pattern is what normally occurs at the end of an economic downturn as firms delay hiring workers until they are confident that improved sales will persist. Second, ING Direct has recently announced plans to add a significant number of workers, providing another needed boost. Third, the local construction sector more than held its own during the downturn and if the recent upturn for local retailers persists, this would translate into more commercial construction. Perhaps even more favorable to local construction firms is that interest rates will likely remain low well into 2004. Finally, many local manufacturers should begin to experience positive effects from the declining value of the U.S. dollar and an expected modest pick-up in the national economy.

The biggest roadblock to a sustained local recovery in 2003 has been the "uneven and uncertain" performance of the U.S. economy. The national economy continues to shed jobs, which has adverse spillovers on consumer spending and business investment. Yet, with the successful conclusion of the "major" combat stage in Iraq and the relative tranquility on world oil markets, a large share of the uncertainty that plagued the U.S. economy has been removed. Also, the recent federal tax cut should have a small stimulative impact in the next year, but bear in mind that most of its effects will be later in the decade assuming that higher budget deficits and long-term interest rates do not choke off growth. Another positive factor is that financial markets have recently stabilized, although we caution that we don't foresee a return to the "irrational exuberance" of the late 1990s. The last piece of the puzzle that would ensure a return to sustained national growth is an upturn in business investment. Toward that end, low interest rates and obsolescence of past technology investments bodes well for a recovery in business capital expenditures—a recovery which reported findings from the **St. Cloud Area Business Outlook Survey** suggest seems to have already begun locally.

National economy continues to shed jobs

It should be noted that we remain somewhat concerned about the effects of heightened global competition (especially from China) on some of the St. Cloud area's largest manufacturing companies. Those area firms that compete directly with Chinese imports are likely to continue to face fierce competition from an increasingly productive Chinese workforce. Relief from this intense competition is unlikely to be found in the declining value of the dollar, since the yuan is pegged to the dollar. Recent international efforts to persuade Chinese authorities to revalue their currency peg have (so far) proved unsuccessful. Should these efforts ultimately prove successful, it would provide some much needed breathing room for some of the area's largest (and most vulnerable) manufacturing enterprises. Finally, we also think the effect of rising health insurance premiums on the key area health sector bears watching. In particular, we fear the area health services industry is slightly vulnerable to provisions in labor contracts that reduce or eliminate employer-sponsored health care benefits. Should employers cut back (as they seem to be doing) on their support for employee health benefits, we expect this to adversely affect the area health-services industry.

The St. Cloud Area Sectoral Outlook

Table 1 shows sectoral employment performance. Reflecting mass layoffs at Fingerhut, retail employment declined 4.8 percent in the year ending May 2003. As noted before, local retailing has displayed some recent strength. Yet, local weakness is centered in manufacturing, wholesale trade, education and health services, financial activities, and state government. Among these sectors, the state of the manufacturing sector is probably most tied to the short-term health of the local economy. We noted above that

Local construction sector remains strong (with the exception of firms competing directly against Chinese products) local manufacturers will benefit from a pickup in the national economy and a depreciating U.S. dollar. To be more upbeat, it is worth noting that St. Cloud MSA manufacturers have outperformed their U.S. counterparts elsewhere. In the five year period ending May 2003, local manufacturers shed only 2.3 percent of their workforce compared to more stark declines of 14.1 percent and 16.4 percent at the state and national levels.

The local construction sector continues to fare surprisingly well in the midst of the local downturn that dates back to late 2001. Over the year ending in May, construction employment is up 2.7 percent, which is well above the comparable 0.6 percent growth rate for Minnesota. Table 2 shows that between February and May, the valuation of St. Cloud MSA residential building permits was about 15 percent above the corresponding level in 2002, indicating that the summer building season will be quite robust. However, the local commercial construction sector appears a little softer and a possible slowing of local population growth may put a damper on residential construction.

St. Cloud Area Labor Market Conditions

Other labor market indicators are shown in Table 2. One seeming anomaly is the 0.2 point decline in the local unemployment rate between May 2002 and May 2003. This can be reconciled by looking at the reports in Table 2 that resident employment declined during the period by about 0.9 percent and the labor force declined an even sharper 1.1 percent, which together produced the fall in the unemployment rate. The rapid decline in the local labor force suggests that many nonemployed residents have either left the area or decided that it is not currently worth seeking work in the current dismal environment. By contrast, Minnesota Workforce Center figures report that the state's labor-force was essentially unchanged during the latest year, showing that St. Cloud's labor-force decline is somewhat unique.

More consistent with soft labor-market conditions is the 25.8 percent decline in St. Cloud Times help-wanted ad linage during the March to May quarter compared to the corresponding period in 2002. On the plus side, new St. Cloud unemployment insurance claims declined about 15.7 percent in March through May compared to 2002, most-

Table 2-Other Economic Indicators

	2003	2002	Percent Change
St. Cloud MSA Labor Force May (MN Workforce Center)	106,359	107,506	-1.1%
St. Cloud MSA Civilian Employment# May (MN Workforce Center)	102,514	103,468	-0.9%
St. Cloud MSA Unemployment Rate* May (MN Workforce Center)	3.6%	3.8%	NA
Minnesota Unemployment Rate* May (MN Workforce Center)	3.8%	3.9%	NA
Mpls-St. Paul/MSA Unemployment Rate* May (MN Workforce Center)	3.9%	4.0%	NA
St. Cloud Area New Unemployment Insurance Claims Mar.-May Average (MN Workforce Center)	502.3	596	-15.7
St. Cloud Times Help-Wanted Ad Linage Mar.-May Average	3378	4418	-25.8%
St. Cloud MSA Residential Building Permit Valuation ($1,000) Mar.-May Average (U.S. Dept. of Commerce)	10,497	9,117	15.1%
St. Cloud Index of Leading Economic Indicators May (SCSU)	119.8	117.7	NA

#- The employment numbers here are based on resident estimates, not the employer payroll estimate in Table 1.
*- Not Seasonally Adjusted
NA- Not Applicable

ly reflecting the surge in new claims due to Fingerhut layoffs in 2002. As shown in Figure 2, firms responding to the **St. Cloud Area Business Outlook Survey** verify that area labor market conditions remain soft. Only 10% of firms indicate it was more difficult finding qualified workers in the most recent quarter and fifteen percent noted less difficulty finding workers. By contrast, four years ago, in the midst of an area labor shortage, 42% of surveyed firms had increased difficulty hiring qualified workers and only 3% found it less difficult to find employees. In addition, in the June 1999 survey, 59% of surveyed firms reported an increase in employee compensation. Four years later, only one-fourth of area firms paid increased compensation in the most recent quarter.

St. Cloud Area Business Outlook Survey

The **St. Cloud Area Business Outlook Survey** is a survey of current business conditions and area firms' future outlook. It is administered quarterly with the cooperation of the St. Cloud Area Economic Development Partnership. Survey results reported in Tables 3 through 6 reflect the responses of 52 area business firms who returned the recent mailing. Participating firms are representative of the collection of diverse business interests in the St. Cloud area. They include retail, manufacturing, construction, financial, and government enterprises of sizes ranging from small to large. Survey responses are strictly confidential. Written and oral comments have not been attributed to individual firms.

Table 3 reports survey results of area business leaders' evaluation of business conditions for their company in June 2003 versus three months earlier. Results from Table 3 are stronger than in the March 2003 survey. Many area firms experienced improved business activity over the past three months. For example, the diffusion index (representing the percentage of respondents indicating an increase minus the percentage indicating a decrease in any given category) for the level of business activity increased from -9.4 to 44.2 in the current period. This represents the best reading of this index since the June 2000 survey. While it must be noted that the relative improvement of the index was more impressive in June 2000 than it currently is (since the economy has been extremely weak in recent quarters), this nonetheless is an encouraging sign. Only fifteen percent of surveyed firms report a decrease in business activity in this most recent quarter while 60% note an increase. Several firms report seasonal effects and one notes that "interest rates are the biggest factor (affecting our business)…new people moving in is another (factor)—they need homes." Another firm notes "increased property casualty insurance, likely increase in property taxes, continued increase in health care costs" are affecting their company. "Financial market performance" has favorably impacted another local company while one company notes that "commercial (insurance) rates continue to increase. Our customers' ability to pay the premium will be and is an issue."

The diffusion index for number of payroll employees, at 13.5, is improved from last quarter, but is the lowest number ever reported in our June survey. One encouraging note can be

Figure 2-Diffusion Index for Question 8: Difficulty Attracting Qualified Workers

Percent Increase Minus Percent Decrease

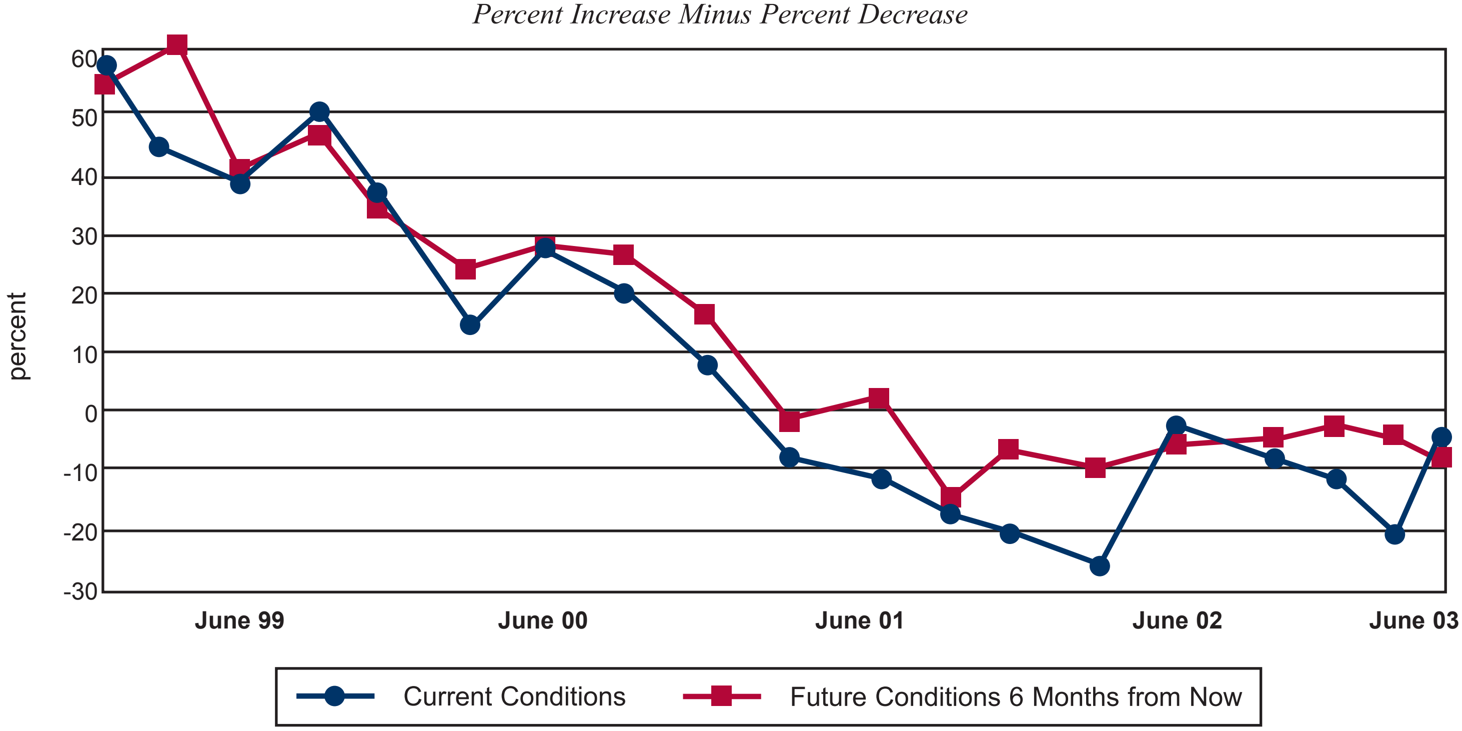


*Table 3--Current Business Conditions**

ST. CLOUD AREA BUSINESS OUTLOOK SURVEY Summary June 2003 *What is your evaluation of:*	June 2003 vs. Three Months Ago				March 2003 Diffusion Index³
	Decrease (%)	No Change (%)	Increase (%)	Diffusion Index³	
Level of business activity for your company	15.4	25.0	59.6	44.2	-9.4
Number of employees on your company's payroll	19.2	48.1	32.7	13.5	-1.8
Length of workweek for your employees	7.7	67.3	25.0	17.3	-9.5
Capital expenditures (equipment, machinery, structures, etc.) by your company	5.8	50.0	44.2	38.4	15.1
Employee compensation (wages and benefits) by your company	1.9	73.1	25.0	23.1	37.7
Prices received for your company's products	13.5	61.5	19.2	5.7	7.5
National business activity	13.5	53.8	19.2	5.7	-17.0
Your company's difficulty attracting qualified workers	15.4	75.0	9.6	-5.8	-20.7

Notes: (1) reported numbers are percentages of businesses surveyed.
(2) rows may not sum to 100 because of "not applicable" and omitted responses.
(3) diffusion indexes represent the percentage of respondents indicating an increase minus the percentage indicating a decrease. A positive diffusion index is generally consistent with economic expansion.

* *SOURCE: SCSU Center for Economic Education, Social Science Research Institute, and Department of Economics*

*Table 4--Future Business Conditions**

ST. CLOUD AREA BUSINESS OUTLOOK SURVEY Summary June 2003 *What is your evaluation of:*	Six Months from Now vs. June 2003				March 2003 Diffusion Index³
	Decrease (%)	No Change (%)	Increase (%)	Diffusion Index³	
Level of business activity for your company	15.4	25.0	51.9	36.5	52.8
Number of employees on your company's payroll	13.5	42.3	38.5	25.0	35.9
Length of workweek for your employees	19.2	65.4	9.6	-9.6	22.6
Capital expenditures (equipment, machinery, structures, etc.) by your company	9.6	59.6	25.0	15.4	20.8
Employee compensation (wages and benefits) by your company	1.9	50.0	40.4	38.5	50.9
Prices received for your company's products	3.8	57.7	25.0	21.2	22.7
National business activity	5.8	51.9	25.0	19.2	20.8
Your company's difficulty attracting qualified workers	13.5	75.0	5.8	-7.7	-3.8

Notes: (1) reported numbers are percentages of businesses surveyed.
(2) rows may not sum to 100 because of "not applicable" and omitted responses.
(3) diffusion indexes represent the percentage of respondents indicating an increase minus the percentage indicating a decrease. A positive diffusion index is generally consistent with economic expansion.

* *SOURCE: SCSU Center for Economic Education, Social Science Research Institute, and Department of Economics*

found in the value of the diffusion index on length of workweek. This index increased from -9.5 last quarter to a current value of 17.3—its highest reading in four years. In the past, area firms typically expanded production by adding new workers. In the most recent period, firms appear to have drawn on their existing work force to increase output. While this observation is subject to alternative interpretations, we see this as an encouraging sign. Sooner or later firms will find it optimal to add to their work force as uncertainty is reduced about the timing, pace, and nature of local recovery and firms will inevitably pull back from the costly practice of achieving output gains by expanding the average workweek. As noted above, the employee compensation diffusion index fell to 23.1, the lowest value recorded since the December 2001 survey. Only one quarter of responding businesses increased employee compensation over the most recent quarter while 2% actually reduced wages and benefits. Nineteen percent of firms report receiving higher prices over three months ago, while 14% note that prices were lower. Local capital spending has finally started to rebound. Forty-four percent of responding firms took advantage of low financing rates and increased capital expenditures last quarter while only 6 percent cut back on capital purchases. The diffusion index of 38 on this survey item is the highest value recorded since the June 1999 survey—indicating that the increasingly expansionary monetary policy is having a favorable impact on the local economy.

Future Conditions

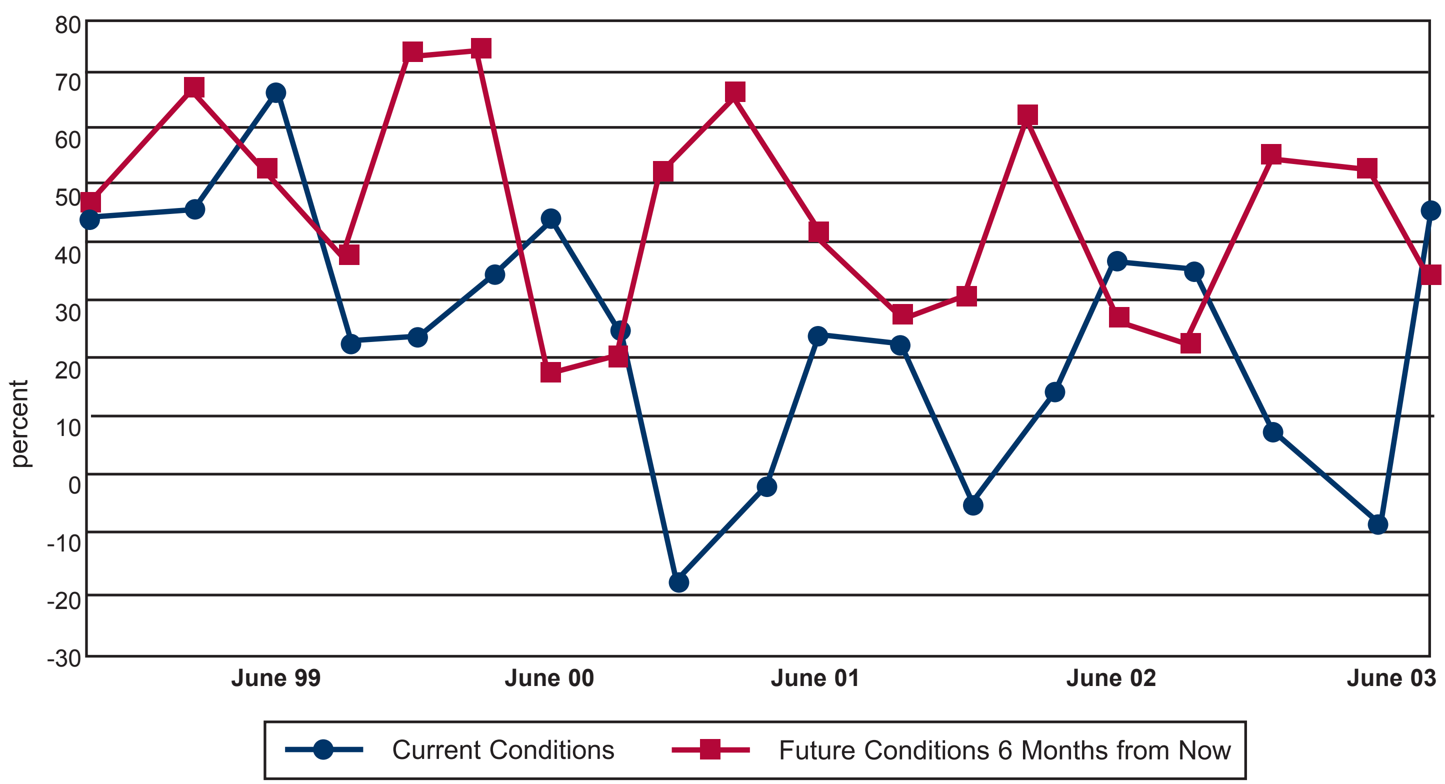
Responses found in Table 4, while not as optimistic as those found in the similar table of last quarter's **St. Cloud Area Quarterly Business Report**, are reasonably upbeat. Summary results from questions related to survey respondents' expectations of business conditions six months from now versus June 2003 are reported in this table. The diffusion index for the question that asks about the level of future business activity for area companies is 36.5. This is down from last quarter's reading of 52.8, but remains well above the 22.6 value reported nine months ago. Going forward, area businesses are for the most part relatively optimistic. Fifty-two percent of surveyed businesses expect improved business conditions over the next six months and only 15% expect conditions to worsen.

When compared to the results of the March 2003 survey, business respondents expect a slightly weaker labor market over the next six months. For example, the index on the survey item which asks about anticipated payroll

Continued on Page 12

Figure 3-Diffusion Index for Question 1: Level of Business Activity

Percent Increase Minus Percent Decrease



Special Question #1: The Extent to Which Area Businesses Expect to be Adversely Affected by the Creation of Job Opportunity Building Zones in Other Parts of the State.

The Minnesota Legislature, at the urging of Governor Pawlenty, recently authorized the creation of as many as 10 “Job Opportunity Building Zones (JOBZ)” in economically distressed areas around the state. All available indications suggest that the St. Cloud area will not qualify to be considered one of these zones since it is not likely to meet the necessary criteria. Proponents of such tax free zones argue that such economic development efforts are successful at creating new jobs in areas that have experienced economic dislocation. These zones create economic resources that would otherwise not be enjoyed by the host community. Opponents of these policies claim that, among other things, enterprise zones simply reallocate existing resources (typically to less efficient uses) and are a costly way to encourage economic development. They argue that precious few new resources are created by these programs—resources are simply redirected. They also express concern that adverse spillover effects may arise from tax-free zones in that it may shift the tax base to payers who do not enjoy such privileges. Others are concerned that zones may drain labor resources from existing areas. These opponents characteristically assert that businesses outside the enterprise zone are placed at a competitive disadvantage in attempting to compete against those enterprises located within the zone. Area businesses were asked to comment on the extent to which they thought their company would be *adversely* affected by these enterprise zones. Responding companies were also given the opportunity to indicate that they expect their business activity to improve as a result of the JOBZ legislation. Area businesses seem to have little concern over this program. Forty-six percent note that they expect “no (adverse) effect” while 31% think there could be a “slight effect”. Only 15% of firms think the effect will be “moderate” or “substantial”. While area businesses don’t feel particularly threatened by this legislation, it is clear that they expect no direct benefits from JOBZ. None of the 52 surveyed firms expect business activity at their company to improve as a result of the JOBZ program.

TABLE 5 — Special Question 1: THE ADVERSE EFFECT OF JOB OPPORTUNITY BUILDING ZONES ON AREA BUSINESSES

Legislation recently created the establishment of up to 10 “Job Opportunity Building Zones” (JOBZ) (tax-free enterprise zones) in economically distressed rural areas of the state. At this point, it appears the St. Cloud area will not meet the criteria to qualify as an enterprise zone. To what extent do you think your business activity will be adversely affected by the creation of Job Opportunity Building Zones in other parts of the state?*

No Effect	Slight Effect	Moderate Effect	Substantial Effect	We Expect this to Improve our Business Activity	NA
46.2	30.8	11.5	3.8	0.0	7.7

* reported results are percent of surveyed businessess.

Selected Survey Responses
Business leaders were asked to comment on the effect of the JOBZ program. These comments include:

- The JOBZ program is a substitute for competitive tax policy vis-à-vis our neighbor states…a band-aid that rewards border areas at the expense of the rest of the state. I hope we can compete with other states from border to border.
- Depends on where the “JOBZ” are located. What kind of “tax free”? Real estate?, Sales?, Unemployment?…Unfair [dis]advantage to the companies who pay the tax, that pays for “JOBZ”.

Special Question #2: The Extent to Which Your Company is Concerned About the Prospect of Potential Future Deflation.

A second special question asked area firms to consider the extent to which they were concerned about the prospects of deflation, a general decline in overall prices. A great deal of recent media attention has been focused on concerns about the economic effects of a declining price level. The Federal Reserve has even indicated some concern about this prospect. The costs of deflation appear to include the transfer of resources from debtors to creditors as fixed interest payments become tougher to make when prices (and wages) are falling. In addition, observers often remark about the potentially destabilizing impact of widespread expectations of future price declines. Such expectations, they claim, can be self-fulfilling and can lead to reductions in aggregate spending that can exacerbate economic fluctuations and can be associated with substantial declines in economic output and personal incomes. They point to the U.S. Great Depression as evidence of the harmful effects of a large deflation. Others point to recent experiences in Japan, where it is often alleged that monetary policy is useless to stimulate economic activity because market interest rates are unable to go any lower than the zero percent rate around which rates have been stuck for several years. These concerns are often translated to the U.S., where some argue the efficacy of monetary policy is becoming increasingly limited as the Fed's key interest rate target has now reached one percent. Other observers believe concerns about deflation are overstated and have called to question the alarmist statements of the anti-deflationary voices. These observers argue that there are many examples of harmless (and even helpful) deflation—including the U.S. in the last quarter of the 19th Century and China in recent years. They note that one needs to explore the nature of any deflation—-whether it is rooted in admittedly harmful adverse shocks in aggregate demand or the highly desirable productivity-driven improvements in aggregate supply. These voices also question the extent to which the U.S. should actually be concerned about deflation—-they point out that we have experienced inflation in every year since the end of World War II—a trend that is not likely to reverse course overnight. Area businesses were asked to indicate the extent to which they were concerned about the prospect of potential future deflation. Results indicate there is some concern about deflation. Sixty-two percent of responding firms indicate they have some concern. More interesting, 34% of firms are either "moderately concerned" or "extremely concerned". This is an issue that we will keep an eye on in upcoming issues of the **St. Cloud Area Quarterly Business Report**.

TABLE 6 — Special Question 2: THE EXTENT TO WHICH YOUR COMPANY IS CONCERNED ABOUT THE PROSPECT OF POTENTIAL FUTURE DEFLATION

There has been a great deal of discussion in recent weeks about the possibility of deflation, a general decline in overall prices. To what extent is your company concerned about the prospect of potential future deflation?*

Not Concerned	Slightly Concerned	Moderately Concerned	Extremely Concerned	We Have Not Considered It	NA
26.9	26.9	25.0	9.6	9.6	1.9

* reported results are percent of surveyed businesses.

Selected Survey Responses
Business leaders were asked to comment on their responses. These responses include:

- We've faced declining sales prices for the past 10 years already.
- We see increases of raw materials, steady to increase in labor, therefore for a result of steady to increased retail prices or our company profits will greatly decrease.

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employment is down from 35.9 to 25.0. Thirty-nine percent of survey respondents expect to increase hiring over the next six months (the corresponding number was 25% in June 2002). The diffusion index on length of the workweek is much weaker than the March 2003 survey (as noted above, this is not necessarily a negative sign for the local labor market). It should also be noted that 40 percent of surveyed firms expect to increase employee compensation over the next six months and only one firm expects compensation to decline. Area firms continue to expect little trouble finding qualified workers. The diffusion index on this item is little changed from its March value.

The survey item asking firms about their future capital spending plans is only slightly less optimistic than was found in last quarter's survey. The value of the diffusion index on this item is 15.4, almost one-quarter lower than it was in March. Twenty-five percent of surveyed firms expect to increase capital purchases over the next six months, while 10% expect to decrease expenditures on equipment and machinery by January 2004. This result may seem surprising in light of historically favorable interest rates, but the survey results reported in Table 3 may help explain this observation. Firms also expect to be able to pass on higher prices by January. The diffusion index on this item is essentially unchanged from its value three months ago. One quarter of area firms still expect to receive higher prices in six months time and 4% of responding firms expect lower future prices. Finally, area firms expect an improvement in national business conditions by the new year. Twenty-five percent of those responding expect national business activity to increase and only 6% expect a deterioration.

An historical view of the evolution of the diffusion indexes on current and future business conditions over the past several quarters is presented in Figure 3. This shows an increase in the diffusion index on current business activity over the past three months. This index is now at 44.2 (its record high of 67.8 was recorded in June 1999, while its low of -19.3 occurred in December 2000). This period's future business activity diffusion index is weaker than last period's reported value. This index is well above its all-time low of 19.7 recorded in June 2000, and is substantially below its value of 61.2 in March of last year. It should be noted that some of this represents a normal seasonal pattern of business activity that has now been observed over the five years that the survey has been conducted.

Participating businesses can look for the next survey at the beginning of September and the accompanying **St. Cloud Area Quarterly Business Report** (including the **St. Cloud Index of Leading Economic Indicators** and the **St. Cloud Area Business Outlook Survey**) in late October. Area businesses who wish to participate in the quarterly survey can call the SCSU Center for Economic Education at 320-308-2157. All survey participants will receive a free copy of the **St. Cloud Area Quarterly Business Repor**t on a preferred basis.