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King Banaian
St. Cloud State University, kbanaian@stcloudstate.edu

Richard A. MacDonald
St. Cloud State University, macdonald@stcloudstate.edu

St. Cloud Area
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AREA ECONOMIC OUTLOOK BLEAK

Executive Summary

Area economic activity has deteriorated significantly in the past several months as a general local economic decline has begun. The area is experiencing an overall reduction in employment with the sole bright spots limited to professional and business services, wholesale trade and federal and local government sectors. Indeed, only 18.3 percent of area private-sector workers are employed in a sector that is experiencing positive year-over-year job growth. Overall, two-thirds of the area labor force is employed in a sector in which employment is declining — led by weakness in construction, manufacturing, retail trade, transportation/warehousing/utilities, leisure and hospitality, and education and health sectors. Year-over-year employment in October 2008 declined by 0.3 percent. The unemployment rate rose from 3.7 percent in October 2007 to 5.1 percent this year — with more than 1,600 more area workers idled than one year ago.

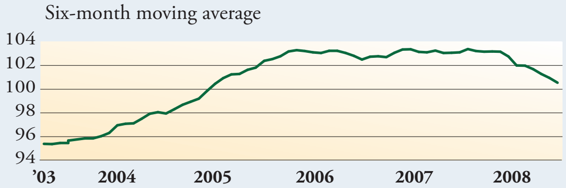
The numbers are similarly bleak in the Twin Cities and statewide. Year-over-year employment through October declined by 0.8 percent in the Twin Cities and fell 0.6 percent statewide. The area economy has a long way to go before it reaches its long-term trend employment growth rate of 1.9 percent. In the 10 years the St. Cloud Area Quarterly Business Report has been written, economic conditions have never been so uncertain. National economic conditions have obviously deteriorated, and the U.S. financial system is under siege. A global recession has emerged, and it is hard to find any encouraging signs of cyclical strength. Key sectors of the economy — notably financial services, construction and automobile industries — face unprecedented challenges. All of this makes predicting the future course of economic activity exceedingly difficult.

With a significant increase in the number of area unemployment insurance claims and a substantial reduction of help-wanted linage in the St. Cloud Times, the local economy entered recessionary territory with a decline of 4.3 percent in the St. Cloud Index of Leading Economic Indicators in the past three months. The probability of recession index remained volatile and finished at a level that suggests a local recession has begun.

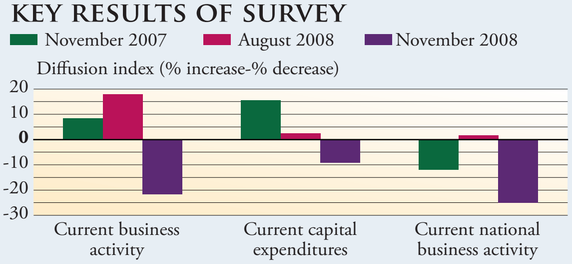
Forty-four percent of surveyed firms report a decrease in economic activity in the past three months, while only 23 percent report an increase. Only 11 percent of surveyed firms increased capital expenditures last quarter, while 21 percent trimmed capital spending. This is the worst performance recorded on this item. Likewise, 41 percent of firms report decreased evaluation of national business activity and only 16 percent think national activity has increased. Three of

INDEX OF LEADING ECONOMIC INDICATORS

Six-month moving average



KEY RESULTS OF SURVEY



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...

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President: Tom Moore
320-656-3815

ABOUT THE AUTHORS

KING BANAIAN
Chairman
Economics Department,
St. Cloud State University
320-308-4797

RICH MACDONALD
Director
Center for
Economic Education,
St. Cloud State University
320-308-4781

the eight items in the current conditions index are at their lowest point in the 10 years in which the St. Cloud Area Business Outlook Survey has been conducted.

The outlook remains bleak. Only 40 percent of the 88 area firms that responded to this quarter's survey expect conditions to improve in six months, while 28 percent expect a decline in business activity. This relative pessimism is found in a variety of items in the future conditions index, where the indexes on future capital expenditures and employee compensation are the lowest recorded and most other index items are weaker than normally reported in the fall survey.

In special questions, there has been deterioration in local firms' access to credit in the past six months, but to date, the credit crisis that seems to have paralyzed businesses elsewhere in the nation has not shown up locally. In addition, area business leaders offer a range of interesting written perspectives on how the U.S. financial crisis is impacting their companies.

Current Activity

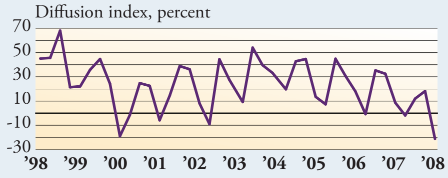
Tables 1 and 2 report the most recent results of the business outlook survey. Responses are from 88 area businesses that returned the recent mailing in time to be included in the report. Participating firms are representative of the diverse collection of businesses in the St. Cloud area. They include retail, manufacturing, construction, financial, health services 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.

Survey responses from Table 1 speak for themselves. For the most part, economic conditions in the St. Cloud area are worse now than at any time since the first survey was mailed in December 1998. The current activity diffusion index is -21.6 — the lowest recorded. The index represents the percentage of respondents indicating an increase minus the percentage indicating a decrease in any given quarter. By comparison, the fall index value is typically +20 or higher. The accompanying chart helps tell the story. One can observe the seasonality of this series by looking at its predictable fluctuations — but the downward drift in this series is unmistakable.

The employment diffusion index turned sharply negative from last quarter's reading, and its current value is the second lowest recorded. With the length of the workweek index, employee compensation index, and difficulty attracting qualified workers index at or near their historic lows, it is evident area labor market conditions have deteriorated substantially in the past three months.

Capital spending plans of surveyed firms help tell the story of area economic weakness. This series has steadily declined to a point at which more area firms report reduced capital spending than report increases. The accompanying chart illustrates the ongoing weakness of area capital spending. It should be noted this series does not exhibit the same seasonal pattern of many of the other series in Table 1. This does not bode well for the future. Firms that expect weaker future conditions shelve capital investment plans until economic conditions are expected to improve.

Current Business Activity



Current Capital Expenditures

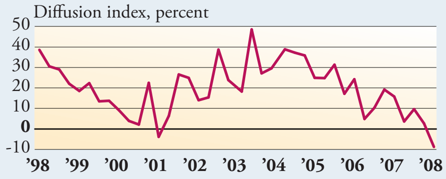


Table 1-Current Business Conditions

	November 2008 vs. Three months ago				August 2008
	Decrease (%)	No Change (%)	Increase (%)	Diffusion Index[3]	Diffusion Index[3]
What is your evaluation of:					
Level of business activity for your company	44.3	31.8	22.7	-21.6	17.9
Number of employees on your company's payroll	26.1	62.5	11.4	-14.7	7.1
Length of the workweek for your employees	19.3	75.9	5.7	-13.6	2.4
Capital expenditures (equipment, machinery, structures, etc.) by your company	20.5	68.2	11.4	-9.1	2.4
Employee compensation (wages and benefits) by your company	4.5	80.7	14.8	10.3	25.5
Prices received for your company's products	21.6	53.4	21.6	0.0	13.1
National business activity	40.9	34.1	15.9	-25.0	1.6
Your company's difficulty attracting qualified workers	15.9	72.7	10.2	-5.7	0.0

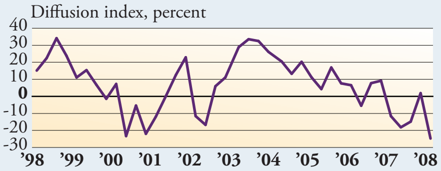
Notes: (1) Reported numbers are percentages of businesses surveyed. (2) Rows may not sum to 100 because of "not applicable" and omitted responses. (3) Diffusion indexes represent the percentage of respondents indicating an increase minus the percentage indicating a decrease. A positive diffusion index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

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

If there is any bright spot in local conditions, it is that any inflationary concerns that may have been present in the August survey have subsided. Indeed, some observers have begun writing about deflationary threats to the aggregate economy. With a 13-point decline in the prices received index (and a 15-point decline in the employee compensation index), this trend will be worth watching in future surveys. Further downward movements in these indexes could suggest deflationary pressures — which is highly undesirable in an economy experiencing challenging credit conditions. Among other things, deflation can increase real interest rates and make it more costly to service existing debt commitments. For the moment, this is not of immediate concern.

Our differing views of national economic conditions can be found elsewhere in this report, but many area firms share our concerns about national business activity. At a value of -25, the national activity index has never been lower (see chart).

CURRENT NATIONAL BUSINESS ACTIVITY



As always, firms were asked to report any factors that are affecting their business. These comments include:

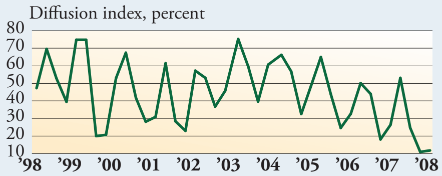
- "Very difficult business environment. Due to loss, no wage increase, no bonus. Health care costs up double digit, had to pass portion on."
- "Our reduction in staff is primarily seasonal. We expect to (rehire) these people in the spring."
- "This is the busiest time of the year for our seasonal (construction) business, but we are expecting an earlier-than-normal slowdown."
- "Fewer construction projects cause more aggressive competition including firms that don't normally focus outside of the metro. Construction costs can be lower as a result but also are causing lower fees to management firms."
- "It appears that first time home buyers will need 15-20% down on home purchases and/or in the alternative, an FHA guarantee."
- "We expect decline in our business in the next three months, also, employee layoffs to increase during the same time period."

Future Outlook

Table 2 reports the future outlook for area businesses. Two of the survey items are at their all-time lowest values and all others are much weaker than normal at this stage of the year. Given this outlook, there is little hope general area economic conditions will improve before April 2009.

As shown in the accompanying chart, the diffusion index on future business activity, at a value of 11.4, is less than one point higher than its all-time lowest value recorded last quarter. Only 40 percent of surveyed firms expect improved conditions in six months' time, and 28 percent expect weaker conditions.

FUTURE BUSINESS ACTIVITY



Future labor market conditions are also projected to be weak. The diffusion index on number of employees is flat, the length of workweek index remains negative, the employee compensation index is at its all-time lowest value, and companies report little expected difficulty attracting qualified workers.

The expected future prices received index is only slightly lower than the normal

TABLE 2-FUTURE BUSINESS CONDITIONS

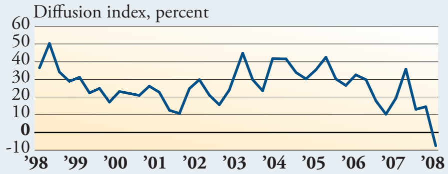
	Six months from now vs. November 2008				August 2008
	Decrease (%)	No Change (%)	Increase (%)	Diffusion Index[3]	Diffusion Index[3]
What is your evaluation of:					
Level of business activity for your company	28.4	26.1	39.8	11.4	10.7
Number of employees on your company's payroll	20.5	55.7	21.6	1.1	-1.2
Length of the workweek for your employees	15.9	71.6	10.2	-5.7	-13.1
Capital expenditures (equipment, machinery, structures, etc.) by your company	19.3	67.0	11.4	-7.9	14.3
Employee compensation (wages and benefits) by your company	4.5	65.9	27.3	22.8	34.5
Prices received for your company's products	10.2	51.1	31.8	21.6	22.6
National business activity	20.5	46.6	20.5	0.0	-6.0
Your company's difficulty attracting qualified workers	15.9	68.2	12.5	-3.4	2.4

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 value, so there is little that can be inferred from this series. Twenty-one percent of surveyed firms expect national business activity to improve by April — a number that is offset by the same number of firms that expect national conditions to worsen.

Finally, the most troubling future business conditions series is the capital expenditures index. At -7.9, the index is at its lowest recorded value. As illustrated in the accompanying chart, the index has never before been negative. This series will have to turn around before a sustained local economic recovery can begin.

FUTURE CAPITAL EXPENDITURES



Special Questions

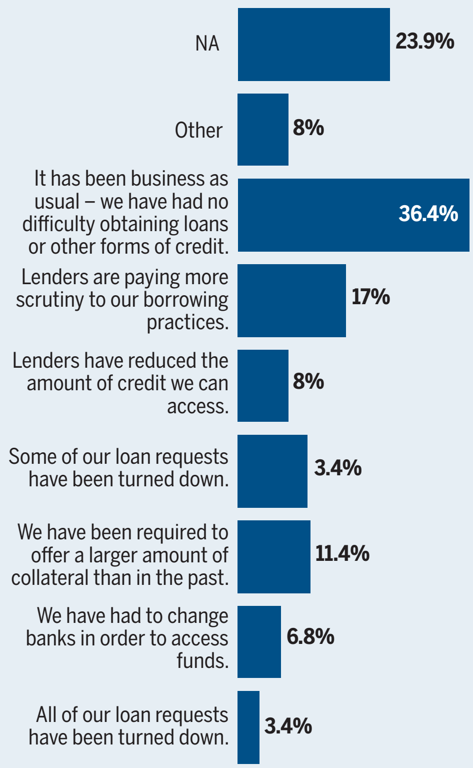
In the May 2008 St. Cloud Area Business Outlook Survey, we asked a special question to measure the extent to which financial turmoil was affecting area firms' access to loans. At the time, it was clear local companies were largely unaffected by the emerging credit crisis. Of course, many firms noted they had not sought access to loans, so they either didn't respond or answered "NA."

We could not have anticipated the financial crisis (and associated credit crunch). Indeed, financial market conditions are an order of magnitude outside any range of activity that we might have imagined could have occurred. So, with a baseline measure of local firms' difficulty accessing credit, we decided to simply repeat the special question we asked in May.

We reminded surveyed firms this special question had been asked six months ago and asked:

QUESTION 1:
"To what extent has recent turmoil in financial markets affected your business' access to loans (or other forms of credit) from banks or other financial services providers?"

The good news is local credit conditions remain largely unchanged from six months ago. While most of the categories reported in the accompanying chart are worse than six months ago, there appears to be no general credit crisis in the St. Cloud area. Of course, some of this is because many firms have not sought loans, and some surveyed firms are banks. But the credit problems that have been so widely reported elsewhere appear to have had a smaller impact locally.



Written Responses to Special Question 1:

• "This doesn't include my loans because I'm OK — (loans to our customers), however … have become more careful."

• "The credit market is very tight."

• "We are once removed from the direct effects of the credit issue. However it has affected us greatly (because there are) less marketing dollars available."

• "We just secured a business loan — no problem."

• "We have not asked for a loan, but I'm sure it would be more difficult if necessary."

• "The financial market stinks — bailouts for large companies — what about small businesses who are struggling?"

• "We have not gone to credit markets, but if we did we would experience higher cost of funds and more scrutiny by lenders."

• "We have not borrowed money. However, our clients continue to report difficulty in borrowing and additional collateral is now required."

• "Although we have not had any difficulty obtaining credit for ourselves, some of our customers who do not have good long term credit history have not been accepted by our standard lenders."

• "Higher rates paid for variable rate debt."

• "We need to protect our asset (cash) and change how it is invested."

• "We are mostly financed by equity, so we have had no difficulty in this area."

The current financial crisis (and economic uncertainty) is so extraordinary it makes it very difficult to think of special questions to effectively measure the extent to which area firms are being impacted. While we knew we would be unable to quantify the responses to our final special question, we decided to simply ask area firms to write about the extent to which their company was being impacted by the financial crisis. Limited space prevented us from printing all the responses, a representative sample is found below. The result speaks for itself. We asked:

QUESTION 2:
Please comment on the way(s) in which the current financial crisis is affecting your business.

Written Responses to Special Question 2:

• "We are having a really good year with sales, but it is a lot harder to collect money that is due to us."

• "People are not spending money."

• "It has slowed business activity and pushed value for our materials down."

• "We depend heavily on new residential construction — need I say more?"

• "Lenders are not providing credit and consumers are not spending. Bottom line — retail suffers and small businesses close. They tease us with lower gas prices, but it's not enough and it's too late."

• "A number of commercial building projects have been put on hold, so we are expecting a dramatic slowdown soon. Our residential business has changed from contractor-driven to consumer-driven."

• "The auto industry is down like I have not experienced in (all my) years in the auto industry."

• "Decreased need, declining sales, slimmer profits, many orders put on hold until January 2009."

• "Slowdown in 'typical' activity. More litigation likely in near future to cover losses."

• "Customers who would like to grow business are more cautious and are delaying decisions or may not be able to get financing."

• "We have three major customers file Chapter 11 resulting in a loss of $131,000 this year."

• "Due to the news media, our customers think they will have a tough time getting credit. But we have no problem with our bank and providing loans to qualified borrowers."

• "Customers are holding on to their money and looking at repairs rather than replacement — new construction is also quite a bit slower and doesn't have a very bright outlook in the upcoming months."

• "Securing consumer credit is more difficult."

• "Accounts are slower paying their bill."

• "We have held off on a new rental building until spring."

• "Cash flow has always been a key factor in success and it continues to be key with a leveraged business. You have to have a keen eye on cash flow."

• "Very sudden decrease in business. Sales continue to decline rapidly."

• "Business is good."

• "Our business has remained fairly stable, but being a small business, when your personal financial is affected, your business decisions are also affected."

Table 3 shows goods-production employment in the St. Cloud area declined sharply in the past year. More than 400 manufacturing jobs were lost locally in the past 12 months. The rate of decline in manufacturing employment in St. Cloud has been less than for the state of Minnesota. Construction employment continues to drop, as the housing slump continues and some larger projects in St. Cloud (such as the new ING facilities and the city library) have concluded. Other public projects, including the DeSoto Bridge, should provide a little improvement in these numbers next year, though residential construction might need to wait.

In the service sector, retail trade and leisure and hospitality employment declined in the 12 months leading to October 2008. Numerous restaurant closings have occurred in the second half of 2008 locally, and scattered reports indicated a decline in seasonal hiring this fall in department stores. Continued strength in professional and business services employment, as well as an increase in public-sector jobs, supported an overall gain of 0.4 percent in service-sector employment. Health and education sector employment slumped.

This widespread weakness has raised the area's unemployment rate to 5.1 percent in October 2008, as seen in Table 4. October is normally a good month for employment, with schools open and retail holiday season hirings in full swing. The rate of 5.1 percent makes it the highest October on record (October 1990 and October 1991 both had 5.0 percent unemployment rates.) The rate normally rises from October through winter and into early spring, so coming from this high a base we can anticipate rates higher than 6 percent in the next few months.

▶ *Continued on Page 37*

TABLE 3 - EMPLOYMENT TRENDS

	St. Cloud (Stearns and Benton)			13-county Twin Cities area			Minnesota		
	15-year trend growth rate	Oct. '07-Oct. '08 growth rate	Oct. '08 employment share	15-year trend growth rate	Oct. '07-Oct.'08 growth rate	Oct. '08 employment share	15-year trend growth rate	Oct.'07-Oct. '08 growth rate	Oct. '08 employment share
Total nonagricultural	1.9%	-0.3%	100.0%	1.3%	-0.8%	100.0%	1.3%	-0.6%	100.0%
Total private	2.0%	-0.5%	84.7%	1.3%	-1.2%	86.2%	1.4%	-0.9%	84.7%
Goods producing	1.6%	-2.5%	21.3%	-0.1%	-4.8%	14.8%	0.1%	-3.4%	16.5%
Construction/natural resources	2.5%	-1.9%	5.0%	2.1%	-8.6%	4.1%	2.0%	-5.1%	4.5%
Manufacturing	1.3%	-2.7%	16.3%	-0.8%	-3.3%	10.8%	-0.5%	-2.7%	11.9%
Service providing	1.9%	0.4%	78.7%	1.6%	-0.1%	85.2%	1.5%	0.0%	83.5%
Trade/transportation/utilities	0.2%	-0.7%	20.5%	0.7%	-1.9%	18.6%	0.8%	-0.8%	19.0%
Wholesale trade	2.0%	2.6%	4.4%	1.3%	-1.1%	4.8%	1.3%	-0.9%	4.8%
Retail trade	-0.6%	-1.4%	12.7%	0.8%	-1.6%	10.2%	0.8%	-0.3%	10.8%
Trans./warehouse/utilities	1.7%	-2.1%	3.5%	-0.3%	-3.8%	3.6%	0.1%	-2.2%	3.4%
Information	1.6%	1.0%	1.2%	0.5%	-0.3%	2.3%	0.1%	-2.3%	2.0%
Financial activities	3.6%	0.2%	4.4%	1.6%	2.7%	8.0%	1.6%	1.5%	6.5%
Professional & business service	6.1%	6.1%	8.9%	1.6%	-3.4%	14.5%	2.0%	-2.2%	11.7%
Education & health	3.0%	-1.6%	15.8%	3.3%	2.1%	14.5%	3.2%	1.6%	15.9%
Leisure & hospitality	2.5%	-1.1%	8.8%	2.0%	1.2%	9.2%	1.6%	-0.2%	8.9%
Other services (excluding govt.)	1.4%	1.6%	3.8%	1.5%	0.0%	4.2%	1.0%	-1.1%	4.1%
Government	1.2%	1.3%	15.3%	1.2%	1.6%	13.8%	0.8%	1.0%	15.3%
Federal government	0.8%	7.1%	1.7%	0.1%	0.4%	1.2%	-0.2%	1.0%	1.2%
State government	1.0%	-1.9%	4.4%	1.8%	3.0%	4.2%	1.1%	1.5%	3.4%
Local government	1.4%	1.9%	9.1%	1.0%	1.0%	8.4%	0.8%	0.9%	10.5%

Note: Long-term trend growth rate is the compounded average employment growth rate in the specified period.

Source: Minnesota Department of Employment and Economic Development and author calculations.

NATIONAL ECONOMIC OUTLOOK

Events in financial markets are unlike any we have observed and, as noted, attempting to make accurate economic predictions is a perilous business in this uncertain environment. For example, the National Bureau of Economic Research recently declared a national recession began in December 2007 — an earlier date than many had thought. While national payroll employment peaked in December 2007, reported gross domestic product data suggest a slow expansion in overall production in the first half of 2008. So, against this backdrop, we decided to offer our individual perspectives on the economic outlook:

Rich MacDonald:

Over the many years of our collaboration, King and I have generally shared similar views on the outlook for the economy — local, state and national. Until recently, I think it is safe to say I have been a shade more optimistic than King about overall economic conditions. However, three months ago, that seemed to change. I am now, I think, the pessimistic one — at least in relative terms.

One thing that troubles me is the modern financial instruments that have been created that make the financial system vulnerable to abrupt swings in economic and financial time series. We now know instruments such as credit default swaps and various forms of financial derivatives can increase overall risk in the financial system. It has been more than 75 years since we have seen spikes in economic and financial time series such as we are now observing — spikes in commercial paper rates, mortgage default rates, foreign exchange rates, oil prices, etc. This makes me fear the worst in terms of the financial tools that may have been created with some of these time series as the underlying instrument. To the extent that these sharp movements in economic and financial time series continue to occur, the U.S. economy will continue to be vulnerable to financial market shocks. One must remember the fundamental problems in equity markets are not, for the most part, investment activity — instead, they largely result from the highly leveraged trading activity that has been pervasive on Wall Street for many years. In many cases these traders are indifferent between whether the market goes up or down — they have learned how to make money in both cases — so they actually benefit from the volatility that has created so much uncertainty in the past several months. When will it be safe to once again have a more optimistic outlook for financial markets and the economy? Keep an eye on the volatility indexes — the VIX, for example. When they begin to find their way back to something resembling their historical average, it will be safe to return to the market as an investor.

The NBER has declared the national recession began in December 2007. My best guess is that it started in August 2008. I do think the recession will continue through June 2009. For me, the uncertain period is third quarter 2009. Sure, the Obama administration will likely pass a fiscal stimulus package that is growing in size with each passing week. I expect this to be no less than $500 billion and maybe higher. Economic forecasters will factor this stimulus into their traditional forecast models and will project a spending-dominated recovery in either the second or third quarter of 2009. In my view, some of this may happen, but I have never been cheered by fiscal policy — in the end, fiscal stimulus involves spending money that we don't have, which, it seems to me, is how we got to this point in the first place. Given that monetary policy is completely focused on trying to avert financial crises, we should not look to policymakers to lead us out of recession — we will have to do this on our own. Helped by lower oil prices, this may happen by the third quarter of 2009. But unemployment rates will still remain stubbornly high. Global Insight Inc., the economic forecasting service used by the state of Minnesota, expects national unemployment rates to peak out at 8.3 percent in the second quarter of 2010!

One of my biggest concerns is that once we emerge from recession, our average long-term economic growth rate is going to be compromised as a result of the financial crisis. During normal times, we can generally expect the economy to grow at about a 3 percent annual rate. I now expect the normal rate of growth to be closer to 2 percent for the next several years. This will compromise living standards in a way that will alter the American dream.

In my view, there are at least three forces that will cause reduced long-term growth — all of which cause a reduction in what economists call "long run aggregate supply." First, there is a dislocation of workers in the financial services industry that will lead to structural unemployment of a large number of highly skilled workers for an extended period of time. Simply put, many of the jobs in this industry will never return. While these resources will eventually become reallocated to alternative uses, this will not occur overnight and is a structural event. How large can this be? Nationwide, 5.9 percent of workers are employed in financial activities (a total of 8,143,000 workers). If this percentage fell to, say, 4.4 percent (which is the share of St. Cloud-area workers employed in this sector), 2 million workers would need to find alternative jobs. It should be noted that 8 percent of the Twin Cities work force is employed in financial activities.

Second, I believe the role of financial intermediation will be fundamentally altered in a way that reshapes the relationship between productive inputs and economic output. In the past several years, there appears to have been little difficulty finding financing for virtually any project. While we now know that much of this financing found its way into investments of dubious quality, there is little doubt that this funding contributed to the expansion of gross domestic product. What happens when we return to the basics and banks and other financial establishments go back to the traditional procedures in allocating credit (renewed credit screening measures, elevated collateral requirements, holding loans on their own books, relying on deposits to fund asset growth, etc.)? This may well cause a shock to the aggregate production function in a way that leads to a reduction in long-term productivity growth.

Finally, the economic role of government has expanded in a way that has not been seen for decades. The government is now in the business of making credit guarantees, has a mortgage loan portfolio, is a direct buyer of commercial paper. The list goes on. The Federal Reserve's balance sheet has expanded by more than $1.2 trillion in the past year. But its highest-quality asset, holdings of U.S. Treasury Securities, has declined by $300 billion in this period. So, the Fed's assets have increased by 138 percent in the past 12 months — but much of this is holdings of paper that no one else is interested in funding. So, how is the government going to unwind all of this activity? That is, how and when are we going to return to an economic system in which risks and rewards are undertaken in the private sector, where economic returns are achieved through productivity improvements? I don't think anyone knows the answer to this, so you can expect lesser productivity gains as long as the economic role of government continues to be elevated to its current state.

King Banaian:

Earlier this year Nouriel Roubini of New York University, who has had a very negative outlook for the U.S. economy, wrote a paper describing recessions as one of four shapes defined by the letters V, U, W and L. The 1907 panic and following 1910 recession are descriptors of a W shape, or a double-dipped recession. Earlier this year I had thought we might be able to hold to a V shape — sharp down in the first half of the year to be followed by an increase in the second half. But the data paused briefly and trended somewhat upward in late spring, only to resume declining again in late summer. When Lehman Brothers collapsed in mid-September, I felt it was time to switch from hopes of a small V-shaped recession to a U-shaped, with a deeper bottom that lasts somewhat longer. I believe that is what we are in now. The L-shape, in which the economy does not resume its normal growth, is what Rich MacDonald describes elsewhere in this report (and that is Roubini's forecast).

Aldous Huxley once wrote that history's charm is that "from age to age, nothing changes and yet everything is completely different." Economic forecasters know this well. Most forecasting consists of looking for a yesterday that looks like today, and then seeing what happened after that yesterday. The comparison is never precise; it is an art one develops with long experience.

In looking for financial panics that have looked most like the present time, the best example I find is the Panic of 1907. A major bank in New York City, Knickerbocker Trust, closed after a run on the bank by its depositors. Private financiers led by J. Pierpont Morgan financed a solution, but some banks were closed and a sharp decline in GDP occurred that year, perhaps as large as 10 percent. (Data is not so precise for that time.) But the following year the economy rebounded and the recession lasted only 13 months. Another recession began in January 1910 and lasted two years, but that one was not financial in nature.

Could we experience that kind of a recession with a second, nonfinancial recession following the first? I do not think so for two reasons. First, without a Federal Reserve in 1907, credit expansion could not happen in the earlier period. The lack of credit may have contributed to the second recession in 1910. Currently the Federal Reserve is extending massive credits to the banking sector. It is not inflationary at present because banks are using that credit to support their balance sheets. Instability of the money supply was a much larger problem in 1907-1912 than now. So I do not believe the W-shaped recession is likely.

Japan of the 1990s is our example of an L-shaped recession. But the lesson of Japan was that policies to combat asset deflation were half-hearted in the first years of the decade. We hear a number of complaints now that the government is doing too much. And it seems highly likely that the government will pass a second stimulus package. The first one, in my view, was insufficiently targeted. Tax rebates mostly go to savings and paying off debt, and since that money must be paid back to government sometime in the future, consumers will reduce their spending to pay higher taxes later.

Second, our current experience is more than just a financial decline. Nationally, the manufacturing sector is in a deep recession, with the Chicago Purchasing Managers Index reaching its lowest levels since 1982. The decline paused during the last economic expansion but did not recover to its 2000 highs either in Minnesota or the St. Cloud area. The same is true nationally.

Despite these wrenching changes, the local economy has not suffered greatly so far, and even held off the recession until after the national and state economies most likely went into recession (see elsewhere in this report for more). And so the financial and nonfinancial shocks are upon us. As close as the financial shock appears to me to be like 1907, the nonfinancial shock then came much later.

Rather than use that historical precedent, I am more inclined to compare the current event to the recessions of 1974-75 or 1981-82. In each case there was financial shock (banks started to lose deposits due to interest rate ceilings after the end of wage-price controls in 1974; deregulation in banking began in 1980-81), though neither as large as the current financial shock. The repercussions of earlier oil price shocks were present as well. In both cases the recessions were longer than average for the postwar era — 16 months, and were U-shaped. But recovery was lengthy and robust in both cases thereafter. To expect the recession to continue into 2010 gives us a U-shape with a bottom much longer than historical evidence suggests. Only four contractions lasted more than 24 months since we started recording cycles in 1854; three of those were in the 19th century. The fourth is the Great Depression.

The question at hand is whether the bottom of the U is three quarters, five or many more than that. With the stimulus package sure to come in the new year, the oil and gas price decline that provides the equivalent of a big tax cut to us now and the resiliency American economic history has demonstrated time and again, I see a bottom that fits the precedents of 1974-75 and 1981-82. Starting from the peak at December 2007 nationally puts the trough — the end of the recession — at April 2009 using these precedents. The housing slump may take a little time to unwind enough to help the construction industry recover, but as lower interest rates work through the banking sector, we should see recovery.

When this happens, the fundamentals of the economy will resume, giving us the growth we have experienced in the past two decades. From 1995-2007, output per hour worked in the U.S. grew at 2.7 percent per year, almost double that of the previous decade. Demographic trends are for less growth in labor supply, spurring businesses to invest in capital and research and development. Financial instability may hinder investment somewhat to slow that number, but I do not foresee a decline to 1970s levels.

What we await is the restoration of trust in financial transactions and between banks, which accounts for the sharp increase in banks' holding cash rather than lending to customers. That will take some time, and no government policy will quicken the rate at which banks will decide to lend again. But lending is how banks make money, and at some point they will. I think sooner, rather than later.

The lack of job opportunities is exhibited by a sharp drop in help-wanted advertising in the August-October period, along with a significant increase in new claims for unemployment insurance in the local area. Building permit valuations continue to decline substantially. Only 303 permits for new single-family dwellings were issued in the 12 months through October 2008, 48 percent less than a year ago and the lowest level since local data started to be collected in 1994.

The reading in Table 4 for the St. Cloud Area Index of Leading Economic Indicators is abnormally low, influenced by a sharp drop in seasonally adjusted help-wanted advertising that month. However, the chart in the Executive Summary shows averaging out the last six months does not change the general conclusion: The index has moved down unmistakably since February, providing a signal of recession beginning in late spring or summer 2008. (More on this to follow.) In Table 5 we show the factors built into that indicator.

A sharp increase in initial claims for unemployment insurance in the area, along

TABLE 4-OTHER ECONOMIC INDICATORS

	2007	2008	Percent change
St. Cloud MSA labor force October (Minnesota Workforce Center)	107,893	108,612	0.7%
St. Cloud MSA civilian employment # October (Minnesota Workforce Center)	103,949	103,032	-0.9%
St. Cloud MSA unemployment rate* October (Minnesota Workforce Center)	3.7%	5.1%	NA
Minnesota unemployment rate* October (Minnesota Workforce Center)	4.0%	5.3%	NA
Minneapolis-St. Paul unemployment rate* October (Minnesota Workforce Center)	3.9%	5.3%	NA
St. Cloud-area new unemployment insurance claims August-October average (Minnesota Workforce Center)	686.7	1,045.7	52.3%
St. Cloud Times help-wanted ad linage August-October average, in inches	5,753	4,174	-27.4%
St. Cloud MSA residential building permit valuation In thousands, August-October average (U.S. Department of Commerce)	7,936.7	5,193.3	-34.6%
St. Cloud index of leading economic indicators October (St. Cloud State University)**	101.7	96.8	-4.8%

MSA = St. Cloud Metropolitan Statistical Area, composed of Stearns and Benton counties.
# - The employment numbers here are based on household estimates, not the employer payroll estimate in Table 3.
* - Not seasonally adjusted
**- October 2001=100
NA - Not applicable

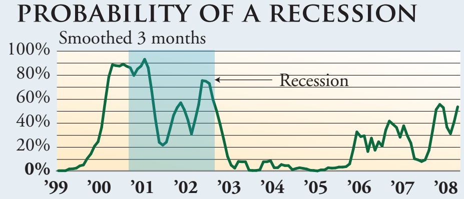
with aforementioned decline in help-wanted advertising, provided almost all of the weakness in the local leading economic index. There was some evidence that the reduction in manufacturing-sector employment might slow, as hours worked for those still employed picked up in the quarter. On a seasonally adjusted basis, new business incorporations were flat in the quarter.

TABLE 5-ELEMENTS OF ST. CLOUD INDEX OF LEI

Changes from August to October 2008	Contribution to LEI
Help-wanted advertising in St. Cloud Times	-1.71%
Hours worked	0.45%
New business incorporations	0.01%
New claims for unemployment insurance	-3.03%
Total	-4.28%

Supporting evidence for the recession comes from our local probability-of-recession index, which showed a greater than 50 percent chance of the economy in recession four to six months from now. That indicator has yet to provide any signal that the recession will come to an end, so we do not think the recession will be short or V-shaped. We cannot say anything from these measures about the second half of 2009; perhaps the recovery begins then,

PROBABILITY OF A RECESSION

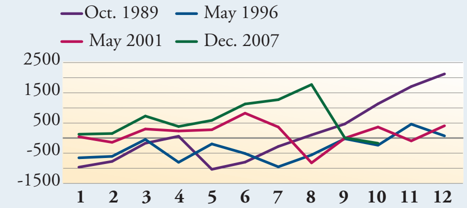


but we do not know yet.

Do we know when the local recession started? We are not yet prepared to make a determination of any date. Local area employment data is subject to substantial revisions, and we experienced ones last year that substantially changed our characterization of the second half of 2007. So we will wait to make any statement on that until the data revisions in March 2009. If the data are not changed much, you would see a picture like that we showed in our last report, which we have updated and put here. The graph shows the cumulative change in employment from the start of the previous three local recessions (as we have identified them — there is no official source) and an assumption that the start of the current recession was in December 2007. That date appears from the data to be too early. The sharp drop in current employment back to the December 2007 level comes in September 2008. It seems the right answer should

EMPLOYMENT AFTER PEAKS

St. Cloud MSA, seasonally adjusted

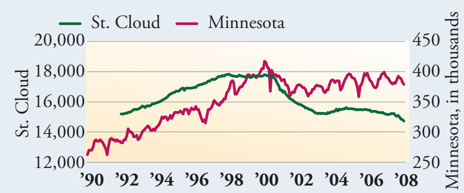


NOTE: Data through October 2008.

be somewhere between those two dates, but until more complete data is received, we cannot be sure.

National forecasters expect a very sharp decline in the fourth quarter of 2008 and the first half of 2009. Due to our greater exposure to the manufacturing recession, and with continued weakness in residential construction, we expect the local recession to continue through the third quarter of 2009. The local area probably experiences weaker-than-average recovery when it does happen as the position of manufacturing in the local economy continues to slide toward state levels. The strengthening of the U.S. dollar recently may make that transition faster, though the dollar's strength may be reversed as lower interest rates and a worsening trade deficit appear to be in our future.

MANUFACTURING EMPLOYMENT



We do not recall any time in the 10 years of this report that our outlook for the local economy has been this negative. The Fingerhut closing, which was the last time we had readings approaching this level, occurred at a time when the national economy was turning around, which gave those whose firms participated in the national and international markets some comfort. We cannot be sure of that this time. That uncertainty has replaced the policy uncertainty surrounding the election that we discussed in the last report. But at least we knew when the campaigning ended. Not so this time.

IN THE NEXT QBR Participating businesses can look for the next survey in February and the St. Cloud Area Quarterly Business Report in the April-June edition of ROI. Area businesses that wish to participate in the survey can call the St. Cloud State University Center for Economic Education at 320-308-2157.