FEDERAL RESERVE BANK OF ATLANTA FOURTH QUARTER 2011

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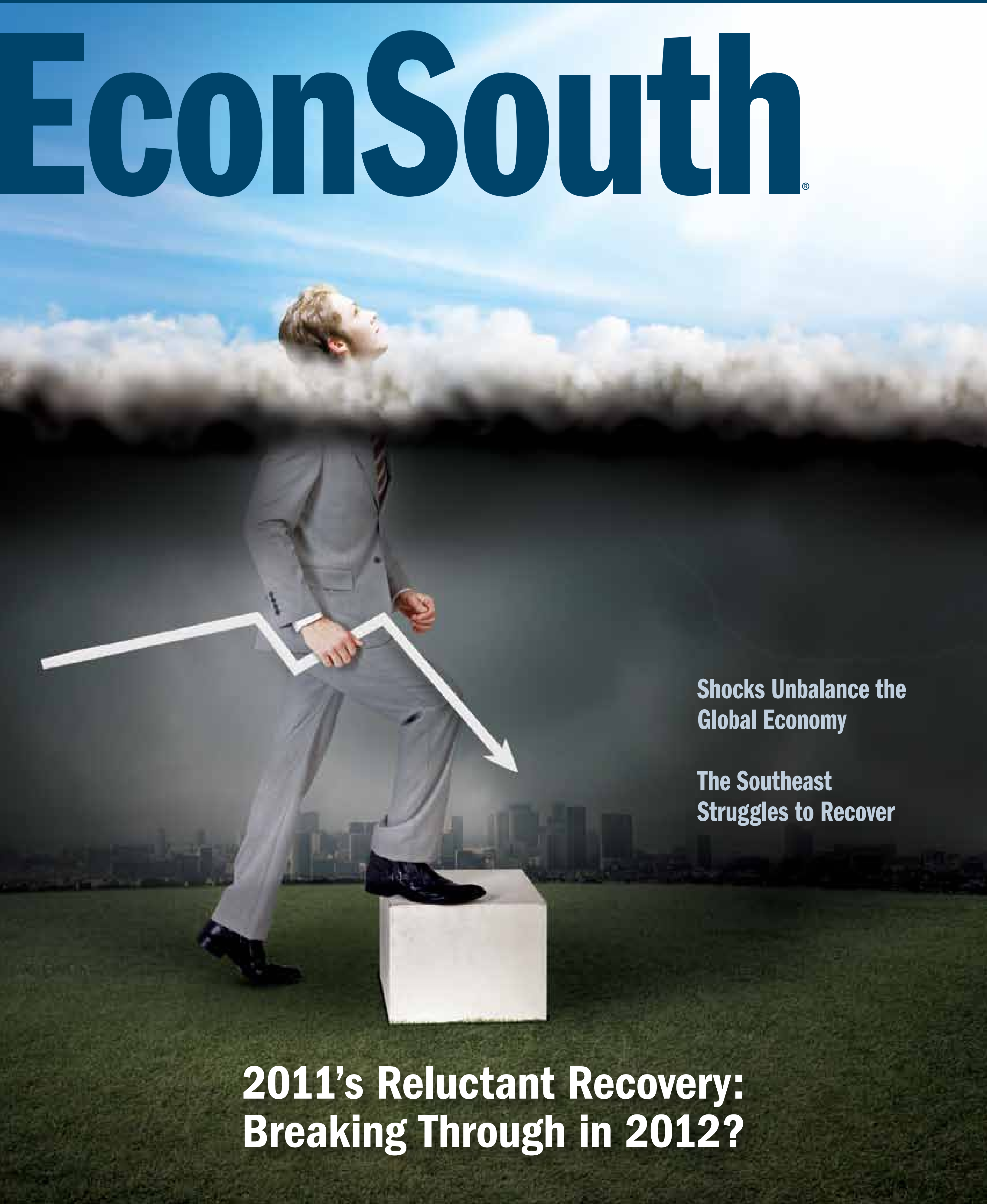

Shocks Unbalance the Global Economy

The Southeast Struggles to Recover

2011's Reluctant Recovery: Breaking Through in 2012?

EconSouth

FEDERAL RESERVE BANK OF ATLANTA FOURTH QUARTER 2011

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DEPARTMENTS

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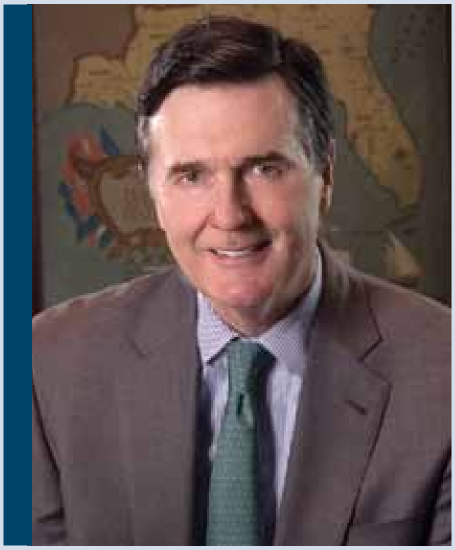
Start-ups, Job Creation, and Financing



DENNIS LOCKHART is the president and chief executive officer of the Atlanta Fed.

Start-up businesses account for a great deal of our country's private-sector job creation, but this important source of new jobs is losing strength and needs attention. During the recession, the pace of new business formations slowed markedly while the failure rate of businesses spiked. A slow rebound in formations since the downturn has not revitalized the start-up sector's job-generating vigor. Accelerating start-up business activity and the accompanying job creation is a worthy mission, particularly amid a jobs crisis.

This is a big challenge. The ecosystem in which start-up companies hatch and grow is highly fragmented and unorganized. It does not lend itself to clear-cut, large-scale solutions. To seriously confront the challenge of strengthening the country's start-up sector, we must understand the underlying commercial reality, including the role of banks as a source of capital.

We often hear that start-ups have insufficient access to capital. This relates importantly to persistent joblessness. If only the banks would lend entrepreneurs more money, the thinking goes, then entrepreneurs would start more businesses, which would create more jobs.

But that claim doesn't hold up. The reality is that banks have not traditionally been the primary financial backers of start-up companies. Entrepreneurs have been far more likely to finance start-ups with personal savings or credit cards than by borrowing from a bank, according to research, including a 2007 survey from the U.S. Census Bureau. So constrained bank credit does not appear to be a major impediment to new business formation and therefore job creation.

Scalable start-ups are the jobs generators

It is important to distinguish between *small* businesses and *new* businesses. Based on sheer numbers, small business as a category is indeed a big employer. Of the nearly 6 million U.S. businesses with paid employees, nearly 80 percent of them employ fewer than 10 people.

Still, it's new businesses, not small businesses generally, that make the most difference in creating jobs. In particular, it's start-ups that grow into medium-sized or large employers—as opposed to

CONTINUED ON PAGE 27

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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 pp. 8, 11, 12, 16, and 20 courtesy of Brad Newton.

The U.S. economy showed some vitality entering 2011, and economists predicted modest growth. But by summer, a series of events—natural disasters, price shocks, and the debt ceiling stalemate, among others—threatened to derail the economy once again. Will 2012 finally see an acceleration of growth?

2011's Reluctant Recovery: Breaking through in 2012?

At the beginning of 2011, most economic forecasters predicted U.S. gross domestic product (GDP) growth for the year would be 3 to 4 percent. After all, the economy had grown at an average 3 percent quarterly annualized rate in the second halves of 2009 and 2010, partially supported by government stimulus and pent-up household demand, and the recovery seemed to be taking hold. But more than two years after the end of the deepest recession since the Great Depression, the U.S. economy continued to undergo significant adjustments and face shocks that have battered the rebound in economic growth.

Shocks to the system

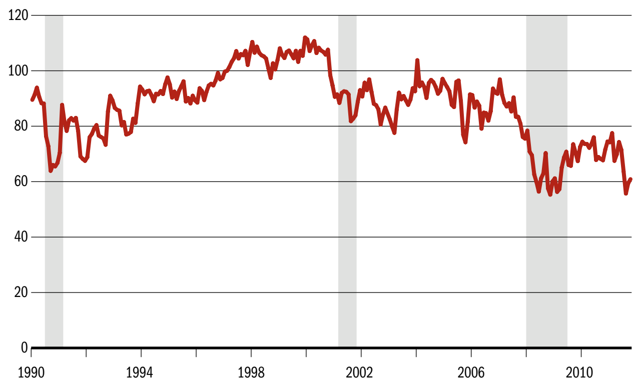
Unfortunately, a series of events in the spring and summer contributed to increased pessimism and much weaker than expected economic growth, which was below 1 percent in the first half of the year. These events included oil and commodity price shocks, the March 11 natural disaster and tragedy in Japan, the debt ceiling standoff in the United States and the resulting downgrade of the U.S. credit rating by Standard & Poor's, Hurricane Irene's destruction on the U.S. East Coast, and growing concern over the European debt crisis.

Improving conditions in the second half of the year were a welcome development. Gains in GDP were finally seen in the third quarter, mainly because of the resolution of some of the factors weighing on the economy in the first half of the year, along with increased investment and consumer spending. However, despite those developments, most forecasters remain skeptical that economic activity will improve dramatically in 2012, as a number of more persistent factors continue to restrain the pace of recovery. For instance, participants at the November 2011 Federal Open Market Committee (FOMC) meeting expect GDP growth in 2012 in the 2.5 to 3 percent range and the unemployment rate to decline only to 8.5 to 8.7 percent by the end of 2012.

Consumer confidence plummets

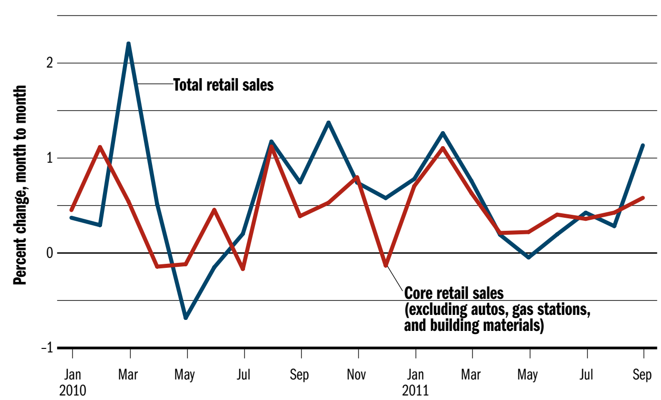
Consumers' behavior is a key aspect of the recovery, as it both reacts to and affects the strength of the economy. Many families continue to face high debt burdens and a constrained ability to borrow. They also own homes whose values continue to be depressed. At the same time, unemployment is high, and

Chart 1
University of Michigan Consumer Sentiment Index



Note: Data are through October 2011 and are indexed so that first-quarter 1966=100. The gray bars indicate recessions.
Source: Thomson Reuters/University of Michigan

Chart 2
U.S. Retail Sales



Note: Data are through September 2011.
Source: U.S. Census Bureau

businesses remain hesitant to expand payrolls. All these factors are reflected in the University of Michigan Consumer Sentiment Index, which fell dramatically during the third quarter (see chart 1).

In this environment, low consumer confidence is likely to continue to depress household spending. In spite of the boost seen in September retail sales activity, total core retail sales, which exclude autos, building materials, and purchases at gas stations, accelerated only slightly (see chart 2). Though consumer confidence improved modestly in October, households remain uncertain about the future, which will likely continue to restrain consumer spending through 2012.

Housing headaches persist

Another factor contributing to consumer uncertainty is the ongoing weakness in the residential real estate market. Depressed property values have eroded household balance sheets. According to the Economist Intelligence Unit, which conducts business and economic research, roughly one-quarter of homeowners with mortgages were underwater in October 2011. Following declines in the first quarter, housing prices began to rise modestly last spring. However, the S&P Case-Shiller home price index remains more than 30 percent below its mid-2006 peak (see chart 3). According to the Mortgage Bankers Association, home values are unlikely to appreciate very rapidly in the near term, with more than 3.4 million mortgage loans either more than 90 days delinquent or in foreclosure at the end of the second quarter of 2011. Foreclosed properties will only add to the already high supply of homes for sale.

Stabilizing the housing market will likely take place only gradually, leaving households to repair their balance sheets through other channels, including continued spending restraint. One bright spot in the housing sector has been the resurgence in the rental market, which has spurred construction of multifamily rental units. Apartment markets have become relatively tight, pushing rents higher and attracting demand for new residential investment.

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Jobs slow to return

Perhaps the factor most weighing on consumer confidence and spending at the end of 2011 is the ongoing weakness in the labor market. One of the most striking and painful aspects of the economic recovery has been its joblessness. Though the recession officially ended more than two years ago, labor markets still have a long way to go to recover lost ground. They were particularly hard hit during the downturn. At the peak of employment in January 2008, there were nearly 138 million employees on nonfarm payrolls in the United States. The gradual pace of improvement over the past couple of years has left the economy with a high rate of joblessness and almost 7 million fewer jobs than when the recession began (see chart 4).

Long-term unemployment is a particular concern because the longer workers are without jobs, the more difficulty they face in developing skills to keep up with changing workforce demands. About 45 percent of unemployed workers have been out of work for more than six months, compared with about 20 percent of unemployed workers out of work for that length of time in the five years preceding the recession. In addition to low underlying demand for workers, the labor market appears to feature a number of rigidities, inefficiencies, and behavioral impediments that may make returning quickly to prerecession levels of employment even more difficult. For instance, contraction of the manufacturing and construction sectors resulted in a large number of unemployed workers with skill sets that may not be easily transferrable to other types of jobs.

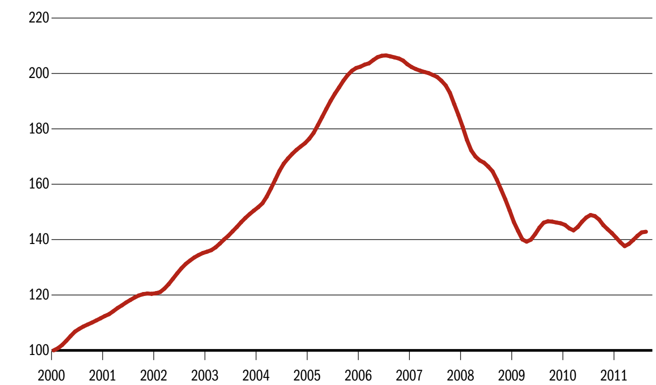
Other potential factors that are making the reduction of unemployment a challenge include employers requiring a wider spectrum of performance competencies than in the past,

After adding an average of 250,000 jobs per month in February to April, employment growth slowed considerably during the summer, as government workforces shrank and private-sector hiring slowed.

changes in government regulations, and some job applicants being unable to pass credit background checks.

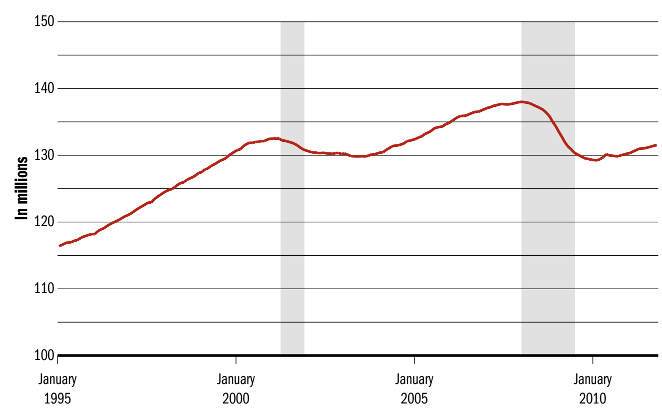
After adding an average of 250,000 jobs per month in February to April, employment growth slowed considerably during the summer, as government workforces shrank and private-sector hiring slowed. In the six months that ended October 2011, the economy added an average of only about 90,000 jobs per month. That level is well below the threshold of around 150,000 to 200,000 monthly, according to Atlanta Fed calculations, necessary to make substantial progress in bringing down the unemployment rate. With the economic growth outlook relatively subdued, and the government sector likely to contract further in response to budget pressures, most economic forecasters expect that job creation will remain relatively modest through next year and unemployment will decline only gradually.

Chart 3
S&P/Case-Shiller Home Price Index



Note: Data are through August 2011, are indexed so that January 2000=100, and are for 20 metropolitan areas.
Source: Standard & Poor's

Chart 4
Total U.S. Nonfarm Employment



Note: Data are through August 2011 and are seasonally adjusted. The gray bars indicate recession.
Source: U.S. Bureau of Labor Statistics

Inflation moderates

A high unemployment rate is consistent with considerable excess capacity in the economy, and is generally thought to constrain wage growth and have a moderating influence on inflation. However, the amount of slack is probably a bit less than it otherwise would have been because of the various rigidities, inefficiencies, and behavioral impediments that economists think may be influencing labor markets.

A number of transitory influences helped fuel higher inflation in 2011. The biggest were an upswing in commodity prices as well as a jump in auto prices because the Japanese disaster induced supply-chain bottlenecks. In fact, the personal consumption expenditure (PCE) price index rose at a pace exceeding the FOMC's long-term inflation objective of 2 percent or less for most of the year. However, inflation began to moderate later in the year as those transitory influences waned. Prices for oil and some other commodities moderated and a resurgence in auto production eased pressure on the prices for cars and light trucks. Additionally, surveys of households and economic forecasters, and measures of investors' inflation expectations derived from Treasury markets, suggest longer-term inflation expectations have remained reasonably stable. The stability of longer-term inflation expectations, combined with resource slack in the labor markets, is likely to continue to restrain inflation

The Financial Outlook in 2012

In 2011 the United States faced a number of challenges that prevented ideal financial market functioning and threatened broader financial stability. These issues may continue to shadow the country in the coming year.

Political gridlock, credit downgrade, and European crisis disrupt markets

In August, after contentious debate, Congress raised the debt ceiling to avoid defaulting on U.S. debt obligations. Not long after, Standard & Poor's downgraded the U.S. credit rating for the first time in history. Meanwhile, Europe's ongoing sovereign debt crisis added to the turmoil and continues to pose risks. The European situation threatens U.S. financial institutions through their direct and indirect exposures to European debt. Given the modest nature of the U.S. recovery, the risks coming from Europe, and underlying vulnerabilities in the U.S. financial system, uncertainty and volatility will likely continue near term.

Nervous investors eye Europe

Financial spillovers from the European crisis figure prominently in the most severe negative scenarios for U.S. financial markets. If financial pressures on European sovereigns continue to escalate, global credit markets could freeze up. European financial institutions with large exposures to troubled economies would come under intense scrutiny, leading to negative effects in the United States. The likelihood of such a financial shock is causing market participants to be risk-averse. And as investors hedge against various negative scenarios—by seeking safety in U.S. Treasuries and gold and by selling riskier assets such as stocks and corporate bonds—U.S. financial markets are suffering from much higher volatility. A comprehensive policy response in Europe would help U.S. financial market functioning.

The financial system may be better prepared for another shock

Despite these challenges, the U.S. financial system should be in a better position to withstand a financial shock than in the past. Banks have made progress in deleveraging from the high debt levels they had before the crisis, and their levels of capital are now higher. However, the deep interconnections embedded within the financial system remain a concern. These concerns include counterparty risk in certain wholesale funding markets, the clearing of derivatives contracts in the wake of a large default, and the potential for acute liquidity pressures on institutions outside the traditional banking system, such as money market mutual funds. ∎

This article was written by Andrew Flowers, an analyst in the Atlanta Fed's research department.

pressures going forward. Participants at the November 2011 FOMC meeting expect inflation as measured by the PCE price index to be in the 1.4 to 2 percent range in 2012.

Looking ahead to 2012

Though modest improvement is likely, it appears that growth will continue to be restrained through 2012. Inflation is likely to return to the 2 percent range, consistent with the FOMC's objective. However, as with any forecast, the economic outlook comes with a number of risks. Most economists' assessments of the risk to the growth and employment outlook are weighted to the downside. Volatility in financial markets, slow jobs growth, and weak consumer confidence make the economy vulnerable to any number of adverse shocks coming from Europe or elsewhere (see the sidebar on the financial outlook in 2012).

Regarding inflation, several factors contribute to a sanguine outlook. The potential for resource slack in the economy placing further downward pressure on inflation expectations is roughly balanced by the risk of upward pressures from commodity prices or other influences supporting inflation expectations.

Atlanta Fed economists anticipate that the process of financial deleveraging within most sectors of the domestic economy will continue to play out, and this paying down of debt is likely to restrain the pace of expansion in 2012 and beyond. In addition, a weaker European economy and shifts in the growth and composition of emerging economies is likely to restrain demand for U.S. exports in the coming year. Relatively high unemployment and a slow pace of employment growth along with little improvement in housing markets are likely to weigh on the confidence of households, and these factors will hold back consumer spending and the expansion plans of business. Confidence will return only as the expansion proceeds and the various economic headwinds dissipate. ∎

This article was written by Laurel Graefe, a policy specialist in the Atlanta Fed's research department.

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The Southeast Struggles to Recover

Economic recovery in the Southeast in 2011 fell somewhere between sluggish and fitful. For every bright spot (Florida's long-chilled housing market is showing signs of thawing), numerous drags on progress remain. In 2012, will the region begin to regain the dynamism that was once its economic hallmark?

The introduction to last year's outlook issue of *EconSouth* began with a suggestion of the bumpy road ahead for the region's economy in 2011: "From its early role as an agricultural center to its current growing significance in manufacturing, the Southeast's economy has continuously evolved in response to economic challenges and changing conditions. In 2011, the regional economy will have to surmount a number of obstacles before it can resume the growth that made it one of the nation's most dynamic economies."

Did the region surmount these obstacles? Has it resumed the growth that made the Southeast so dynamic? Unfortunately, the answer is no. Not completely, anyway. While the region made some progress along the road to recovery, many impediments remain.

The challenges the region faces are similar to those faced by the nation as a whole, but many of these barriers have proven especially tough to overcome in the Southeast. A persistent decline in construction and development in particular made regaining solid economic footing difficult.

The driving force behind the region's economic growth over the years has been robust population growth, which ignited development and spurred job creation. The slowdown in population growth to the levels experienced by the rest of the country explains a big part of the regional economic contraction, and lagging in-migration appeared to continue in 2011. For example, U.S. Census Bureau data from Florida show that from 1980 to 2007, the state averaged an annual growth rate in population of nearly 2.5 percent. From 2008 to 2010, that rate declined to less than 1 percent. Georgia's population growth declined from an average annual gain of 2 percent (1980–2007) to 1 percent by 2010. Population growth in the United States has held at a fairly consistent 1 percent for decades (see chart 1).

Demographers at the University of Florida's Bureau of Economic and Business Research (BEBR) do not foresee a quick return to population growth in the Sunshine State, which had averaged annual gains of around 300,000 in the last three decades. According to Stanley Smith, director of population studies at the BEBR, annual population increases for the state are not projected to reattain that level until 2014 or 2015.

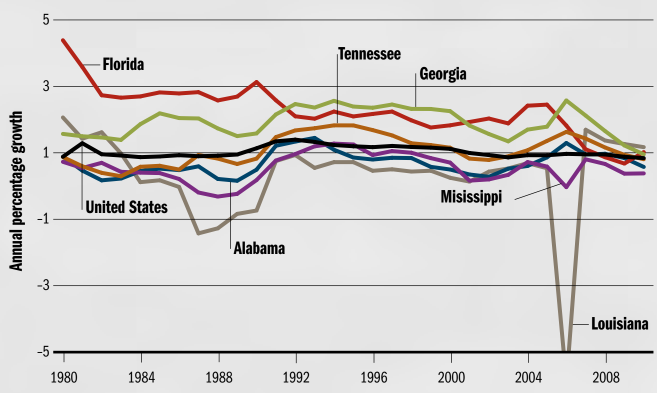
Real estate remains suppressed

The dynamic between population and economic growth is quite nuanced, but when real estate developers anticipate steady population gains that fail to materialize, serious imbalances can result. Construction of homes and commercial space does not stop on a dime, hence the high degree of overbuilding apparent in many parts of the region. Housing demand remained historically low in 2011, according to regional business contacts, while commercial property vacancy rates—especially for retail space—barely budged from 2010 levels. Add in continued falling home prices, and it is little wonder that the real estate sector remained a drag on the region's economy in 2011.

Data show that new home construction, as measured by permits issued for new residential buildings, remained near historic lows in 2011 for southeastern states (see chart 2).

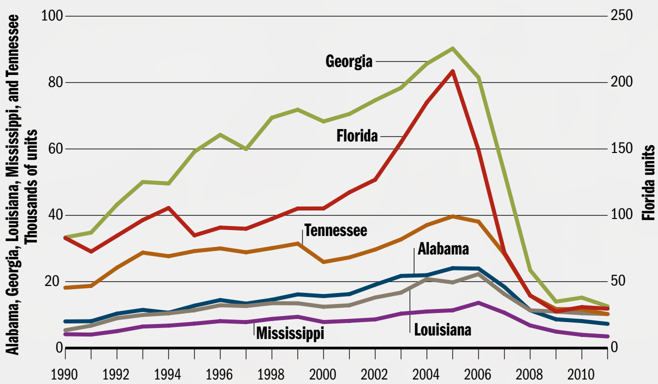
Multifamily construction permits also remained near historic lows, although apartment vacancy rates have declined throughout 2011. Ron Johnsey, president of Axiometrics Inc., an apartment market research firm, recently discussed the multifamily market with the Atlanta Fed's Real Estate Analytics Center in a podcast. He noted that "the multifamily real estate market is performing at the highest level I have seen in over 15

Chart 1
Population Growth



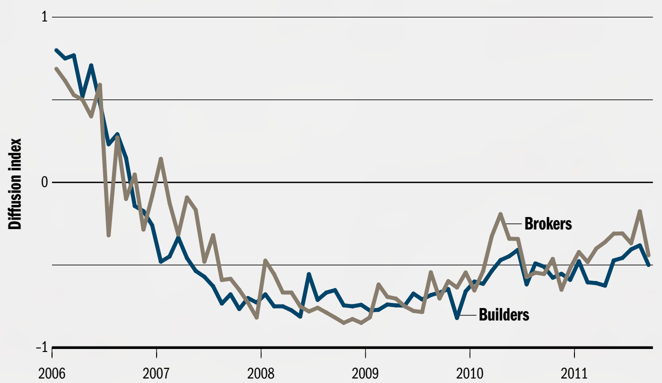
Note: Data are through 2010. The sharp drop in Louisiana's population in 2006 was due to Hurricane Katrina—the population fell 6 percent between 2005 and 2006.
Source: U.S. Census Bureau

Chart 2
Annual Single-Family Home Permits



Note: 2011 figures are based on fourth-quarter 2011 permit forecast.
Source: U.S. Census Bureau

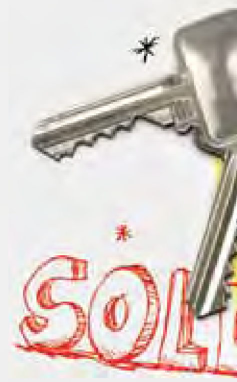
Chart 3
Southeast Home Prices versus a Year Ago



Note: Data are through September 2011. A diffusion index number less than 1 indicates more survey respondents reported home prices were lower than a year ago.
Source: Federal Reserve Bank of Atlanta business contact poll

years that I've been in this business." Johnsey explained that "there is less interest in owning homes because the buyer sentiment is just not there. The renters who would move out to buy homes, they see the home prices declining, they see that they have to have higher down payments, better FICO scores, and so on, and all of this is working to create more renter demand for conventional market-rate apartments."

Declining home prices weigh on homeowners as well as on potential homebuyers. Data from multiple sources show that the value of existing homes in the Southeast remains at or near recent lows, and prices continue to decline in several areas. Prices for new and existing homes remain below year-ago levels (see chart 3).



Existing home sales data showed little improvement in 2011 in most southeastern states. However, sales in Florida continued to improve, bucking the regional trend. Reports from industry contacts revealed that sales were most pronounced in the condominium sector, with a significant portion of these sales carried out in the form of cash transactions by investors and international buyers. Data from Realtors in Florida indicated that condo sales were up 18 percent year to date in September 2011 compared with the same period in 2010, and single-family home sales were up 8 percent over the same time period. In southeast Florida (Fort Lauderdale, Miami, and West Palm Beach), condo sales were up 29 percent year to date through September compared with a year ago.

From a housing perspective, another part of the region that appears to be doing better than the others is Louisiana. The National Association of Homebuilders (NAHB) reported that 23 markets in the United States qualified as "improving" in September. The NAHB classifies a metro area as "improving" if it shows an increase in housing permits, employment, and housing prices for at least six consecutive months. Alexandria, Houma, and New Orleans all made the list. No other metro area in the Southeast region did.

The rest of the region continued to experience very weak home sales. Responses from the Atlanta Fed's monthly poll of residential brokers and homebuilders in the Southeast indicated that new home sales remained below 2010's weak levels, while existing homes sales were largely on pace with 2010's poor volumes. District builders and brokers anticipate only modest sales growth going into 2012. Although existing home sales in most states in the Southeast are improving, the improvement is taking place in fits and starts (see chart 4).

Commercial construction activity also remained very subdued in 2011, although contractors noted some improvement as the year went on. Half of the commercial contractors the Atlanta Fed surveyed in September reported that construction activity was up slightly from earlier in the year. They also noted an increase in backlogs. However, the outlook among commercial contractors remained weak—most anticipate commercial development for the start of 2012 to be flat or down compared with a year ago.

Commercial brokers in the region remarked that market dynamics continue to largely favor tenants, particularly in the retail sector. However, some reports indicated that available office space had declined, and with little new office development under way, rental rate increases are a possibility. Other brokers pointed out that smaller blocks of office space remain abundant on a sublease basis from tenants who have downsized but are still paying for unused space.

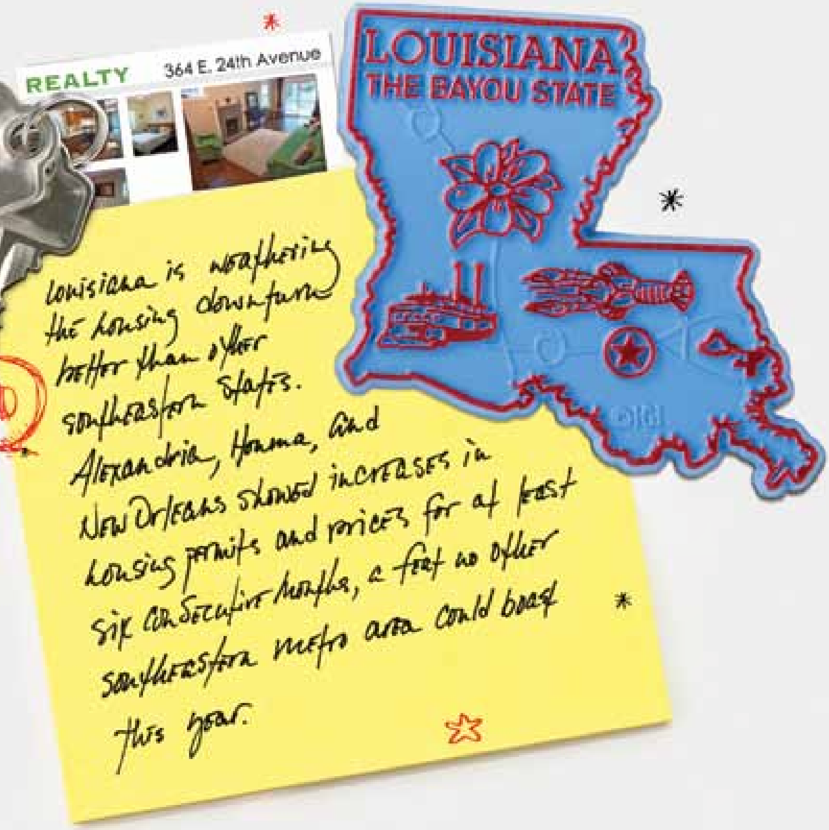
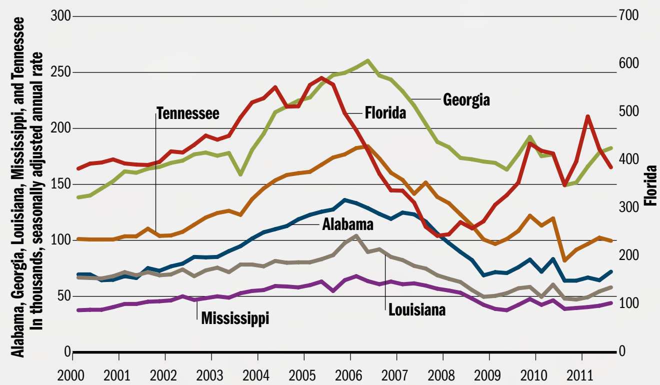
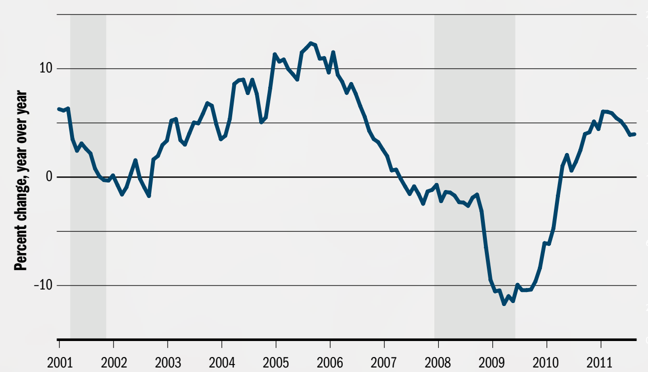


Chart 4
Southeast Existing Home Sales



Note: Data are through September 2011.
Source: National Association of Realtors

Chart 5
Southeastern State Governments' Sales Tax Revenues



Note: Data are based on a three-month moving average and are through September 2011.
Sources: Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee state departments of revenue

Consumers remain wary

Weak real estate markets, especially declining home prices, have placed additional strain on household balance sheets. As a result, people are cautious about spending. Consistent with national retail sales data that revealed a deceleration in consumer spending over the summer months, Atlanta Fed retail contacts expressed increasing concern about the disappointing sales in southeastern stores. However, many discount operations and several luxury goods dealers reported strong sales activity.

Positive sales results have not shielded some luxury goods producers and sellers from market stresses. "The jewelry industry continues to be challenged with high commodity prices and weak consumer sentiment but is beginning to reinvent itself to meet consumers' desires by utilizing technology and an improved supply chain," said Matt Stuller, founder and chairman of Stuller Settings Inc., one of the largest jewelry manufacturing and distributing firms in the United States and a member of the board of directors of the Atlanta Fed's New Orleans Branch.

A few home improvement retailers also appeared to benefit from an increase in remodeling and renovation activity. Inventory levels for most retailers in the Southeast remained lean as businesses hesitated to build up excess stock until demand improved. Overall, sales tax data from the states in the region indicated modest declines over the summer after posting solid gains early in the year.

Southeastern states' sales tax revenues were up 4 percent in September 2011 compared with the same month in 2010. Year-over-year gains in sales tax collections began to pick up around the third quarter of 2010 and accelerated through the first half of 2011. Annual gains in collections began waning, however, over the third quarter of 2011 (see chart 5).

Tourism rebounds in 2011

Although consumers were clearly watching their discretionary spending, they did not sacrifice vacations in 2011. Leisure and business travel remained strong in the Southeast throughout the year. Theme park attendance, occupancy rates, room rates, and cruise line bookings all increased. Both airport and cruise traffic improved throughout the year.

International visitors bolstered activity, mainly in Florida, where tourism reports have been very healthy. VisitFlorida, the state's tourism marketing arm, estimated that the total number of visitors to Florida was up nearly 7 percent in the first half of 2011 compared with the first half of 2010.

"The increase in Florida's tourist activity has been a result of both domestic and international travelers," said Walter Banks, president of Lago Mar Resort and Club in Fort Lauderdale and a member of the Atlanta Fed's Miami Branch board of directors. "The large population in the state has added to the activity as have the international travelers from areas like South and Central America, Europe, and Canada.

"Tourism activity grew in Florida in 2011 as the visitors started returning because of pent-up demand and the ease of accessibility to Florida's cities through the airports and the seaports," he added. "The increased activity benefits many economic sectors, including hotels, restaurants, retail, cruises, [and] attractions, and also adds jobs."

The Florida Department of Revenue also reported that tourism and recreation taxable sales in the first half of 2011 increased nearly 6 percent over the same period in 2010. It projects a continuation of tourism activity with a nearly 4 percent increase estimated in 2012 over 2011 (see chart 6).

The Gulf Coast rebounded from last year's oil spill, which had chased away beachgoers and recreational fisherman from Louisiana to Florida's western shores. Consider the following quote from the Mobile *Press-Register*'s report from the Alabama coast on July 4, 2010: "The sun shone, the sand glistened and the water was pleasant Sunday at Dauphin Island's public beach. There was only one thing missing from this otherwise perfect Fourth of July: People. On the 76th day of the ongoing oil spill disaster, only a couple dozen visitors were at the beach at 1:30 p.m. on what is usually one of the busiest days of the summer."

Now consider the Associated Press coverage from the Alabama coast on July 4, 2011, which contained this report: "State officials are expecting a big week for tourism along Alabama's coast.… Promoters say almost all of the 17,000 condominiums and hotels in southern Baldwin County are full through the Fourth of July. The area's 2,500 camp sites also are occupied, and many guests are staying through next weekend."

What a difference a year makes.

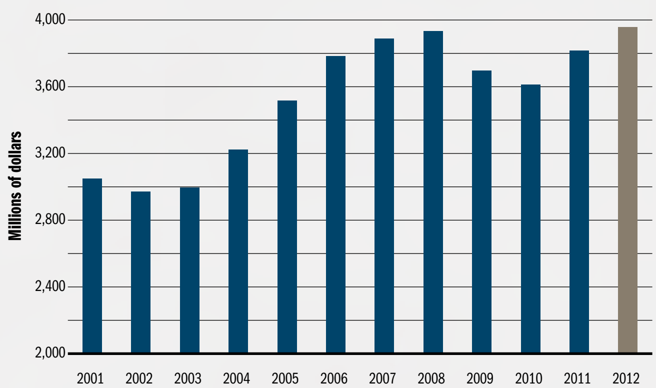
Business travel improved and convention attendance was stronger in 2011 than in the previous two years. Regional festivals also drew large crowds. Mardi Gras in New Orleans and Mobile attracted approximately 1.2 million and 800,000 people, respectively, this year. The Jazz and Heritage Festival in New Orleans brought in an estimated 550,000 visitors. Knoxville's Boomsday Festival drew 400,000 people, while more than 1 million people made the trip to the Miami Carnival.

Manufacturing remains a mixed bag

While tourism's strength has been an important counterweight to weakness elsewhere, the negative impact of real estate and construction has clearly spilled over into other sectors. For example, the manufacturing of goods tied to residential and commercial building has not rebounded. According to contacts in Dalton, Georgia—a major U.S. center for production of carpet and flooring—manufacturing output in the area declined by nearly a third in 2008–09. (Georgia is home to more than 70 percent of U.S. employment in carpet and rug manufacturing.) Production remained flat in 2010 and, during the first half of 2011, manufacturing employment in Dalton continued to fall, indicating the industry continues to suffer from a stagnating construction sector.

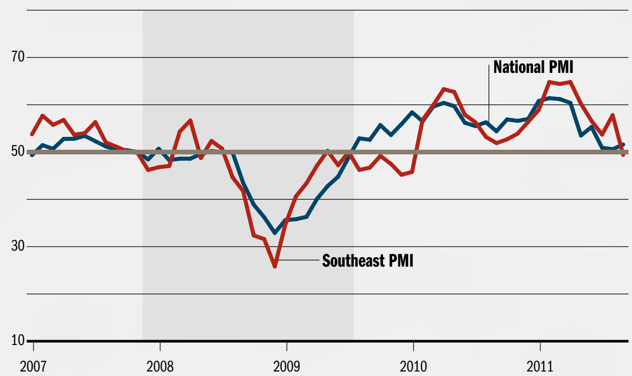
Taking a broader view of manufacturing in the region, the picture is mixed. Auto production has rebounded from the supply chain disruptions caused by the Japanese earthquake and tsunami in March. Existing facilities in Alabama and Tennessee have increased output in 2011, and the Kia Motors plant in West Point, Georgia, is running at planned capacity of 360,000 units per year. In September, the plant added a third shift, bringing the total number of jobs created by the Kia plant to 3,000. Volkswagen's new plant in Chattanooga began production in the first quarter of 2011, and General Motors recently announced that it is going to reopen its plant in Spring Hill, Tennessee, in early 2012, bringing back about 1,700 jobs to the area. The General Motors

Chart 6
Florida Sales Tax Revenue from Tourism and Recreation



Notes: Results are for the fiscal years ending in the indicated years. Tax revenue for the fiscal year ending in 2012 is an estimate.
Source: Florida Office of Economic and Demographic Research

Chart 7
Southeast and National Purchasing Managers Indices



Notes: Data are through September 2011. 50+ index points = expansion.
Sources: Kennesaw State University, Institute for Supply Management

Spring Hill plant formerly produced Saturn vehicles but ceased production in June 2009.

Producers of high-tech equipment also fared well in 2011. Tom Stanton, chairman and chief executive officer of ADTRAN and chairman of the Atlanta Fed's Birmingham Branch board of directors, said that service providers' capital expenditures continued growing in the third quarter of 2011, with forecasts showing a 6 percent annual increase for 2011. "Likewise, worldwide enterprise spending is also up nearly 8 percent year to date," Stanton added. "This growth is being driven by the need for premium broadband services and the demand for new architectures to meet this growing need."

Another bright spot in manufacturing was energy extraction and production equipment. Atlanta Fed energy sector contacts, mainly in southern Louisiana and Mississippi, reported an increase of production of drilling materials since early 2011. According to industry experts, new drilling technology has reduced costs and increased extraction capabilities for both oil and gas, keeping industry plans to increase production capacity on track.

Broader indicators of regional manufacturing held up well throughout most of 2011. Kennesaw State University's Purchasing Managers Index for the Southeast (the methodology for the index mirrors the Institute for Supply Management's national measure) indicated an expanding manufacturing sector from early 2010 through August 2011, but the index slipped below 50 in September (see chart 7), hinting that factory activity had declined that month (see the box).

Atlanta Fed logistics contacts remained upbeat throughout most of 2011, although many contacts noted some deceleration in shipments in the late summer and early fall. Despite the slowdown, they report that volumes of shipments are above last year's

Understanding the PMI

The Econometric Center at Kennesaw State University, partnering with local purchasing associations and the Federal Reserve Bank of Atlanta, prepares the monthly Southeast Purchasing Managers Index (PMI) Report. Purchasing managers across the Southeast use this report to compare the current conditions in their market with the broader manufacturing sector as well as to plan future purchasing decisions.

The survey consists of five questions that gauge the economic health of manufacturers. Purchasing managers respond to questions about the current month's level of new orders or sales, production, employment, supplier deliveries, and finished inventory versus the previous month. The researchers use the answers to each question to calculate a diffusion index, which measures the difference between the number of respondents saying, for example, that new orders are increasing versus those who say they are decreasing.

Responses to the questions are equally weighted and indexed to a scale where a reading above 50 is roughly indicative of growth and one below 50 is usually an indication of contraction. ∎

Regional story continues on page 16

Small Businesses Feeling the Pinch

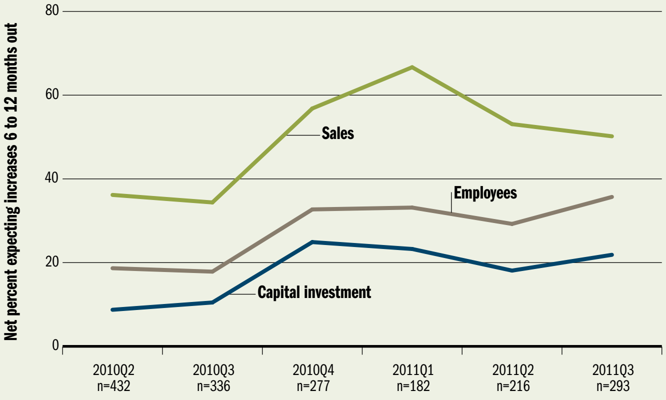
On a quarterly basis, the Atlanta Fed conducts a poll of small businesses in the Southeast. Although the poll is not statistically representative, its recent findings suggest ongoing strains on smaller enterprises, mainly the result of slow sales and tight credit conditions.

According to the third quarter survey, the net portion of firms anticipating hiring additional staff increased from the second quarter of 2011 to the third quarter of 2011. The outlook for capital investment spending for small firms also increased. Despite a more positive outlook for hiring and capital expenses, the outlook for sales growth worsened. Among firms not involved in construction or real estate, the net percent of firms expecting higher sales decreased from 53 percent in the second quarter of 2011 to 51 percent in the third quarter of 2011 (see chart 1).

This improvement in expectations for hiring and capital investment came on the heels of a sharp reduction in sentiment across all three dimensions in the second quarter of 2011. The decline in sales expectations was broad-based across industry and firm age, while the increase in hiring expectations stemmed primarily from firms in the service and the trade, transportation, and utilities industries and from firms that have been in business for less than six years.

Chart 1

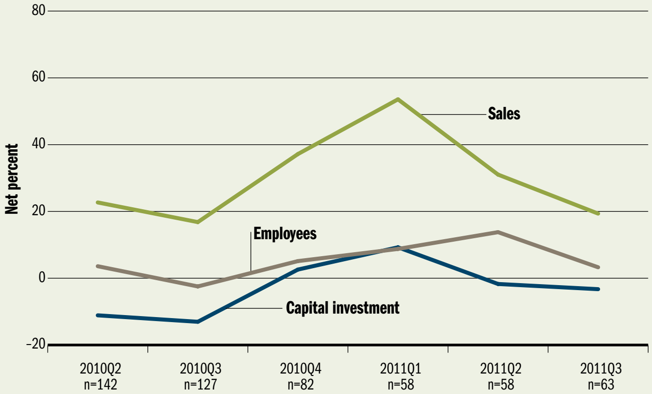
Business Expectations, 6 to 12 Months Out: Firms Not in Construction and Real Estate



Note: "n" indicates the number of firms responding to the survey in that quarter.
Source: Federal Reserve Bank of Atlanta Third Quarter 2011 Small Business Survey

Chart 2

Business Expectations, 6 to 12 Months Out: Construction and Real Estate Firms



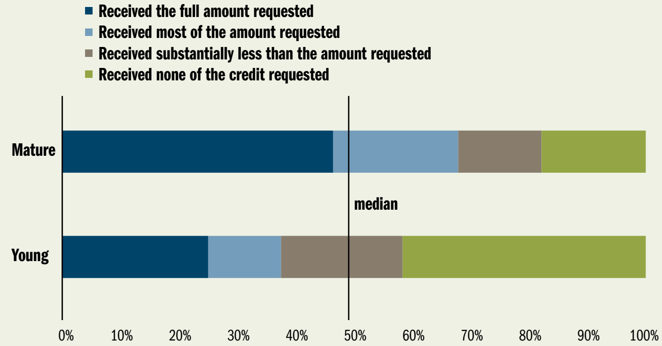
Note: "n" indicates the number of firms responding to the survey in that quarter.
Source: Federal Reserve Bank of Atlanta Third Quarter 2011 Small Business Survey

Firms, particularly in the construction and real estate industries, continue to face tough challenges. In addition to having a more pessimistic outlook than other industries over the past six quarters, firms in these industries had even lower expectations for sales and employees in the third quarter of 2011 (see chart 2).

While the majority of mature firms in the survey reported receiving the full amount of money applied for in the third quarter of 2011, credit did not come easily to all. In particular, younger small businesses were more likely to report applying for credit to expand their business and also more likely to be denied

Chart 3

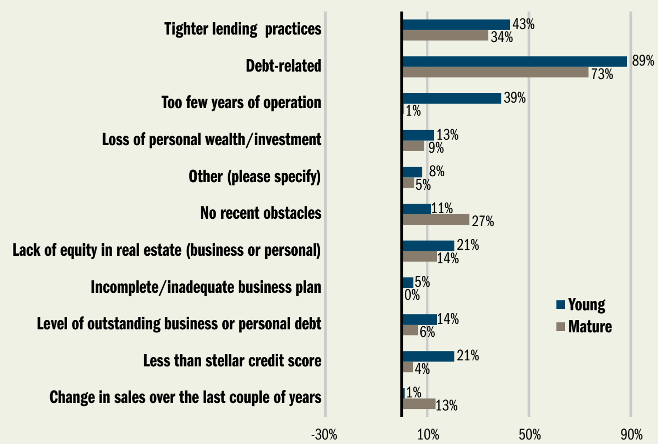
Extent to Which Overall Financing Needs Were Met, Construction and Real Estate Firms



Source: Federal Reserve Bank of Atlanta Third Quarter 2011 Small Business Survey

In the Southeast in 2011, younger small businesses seeking bank loans for expansion generally encountered a more challenging lending environment than mature firms.

Chart 5
Obstacles to Credit: Firms Other Than Construction and Real Estate



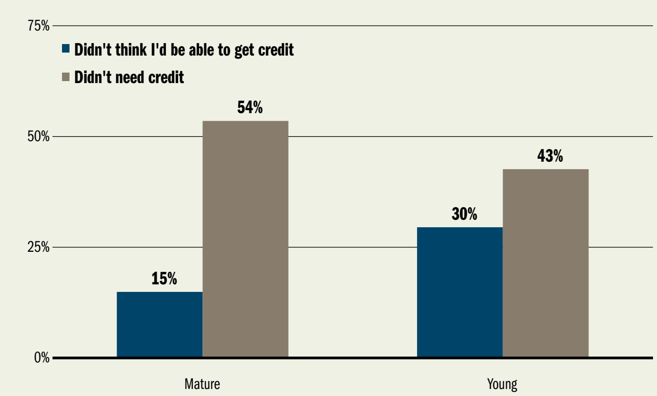
Source: Federal Reserve Bank of Atlanta Third Quarter 2011 Small Business Survey

or offered undesirable credit terms. Excluding firms in construction and real estate, the median young firm in the survey reported receiving only some of the credit requested in all their applications for credit. The median mature firm, however, reported receiving most of the credit requested (see chart 3).

Seventy percent of young firms and 58 percent of mature firms did not borrow in the third quarter. When asked why, most firms indicated they did not need credit. However, many firms avoided applying for credit because of the expectation that they would either be denied or offered unfavorable terms. In the third quarter of 2011, almost one-third of firms less than six years old and 15 percent of mature firms did not attempt to borrow for these reasons (see chart 4).

The strict credit standards prevalent in today's lending market also appear to be affecting the way start-ups are financed. Using personal savings for initial capital is reportedly a much more common way to start a business than in the past. Two-thirds of firms less than six years old used personal credit to start their businesses, compared with only half of mature firms. A loan or line of credit from a bank was also a much more common way of starting a business for the more mature firms in the sample. Young firms are inherently more risky and often reported being turned down for not having enough collateral. When asked about credit obstacles, firms under six years old were much more likely to cite multiple barriers associated with lower creditworthiness, including level of outstanding debt, blemished credit score, and not enough years of operation (see chart 5). ∎

Chart 4
Reason for Not Borrowing



Source: Federal Reserve Bank of Atlanta Third Quarter 2011 Small Business Survey

Continued from page 13

Chart 8
Loan Growth in Southeastern States

Note: Growth is calculated quarter to quarter.
Source: Bank call reports, SNL Financial

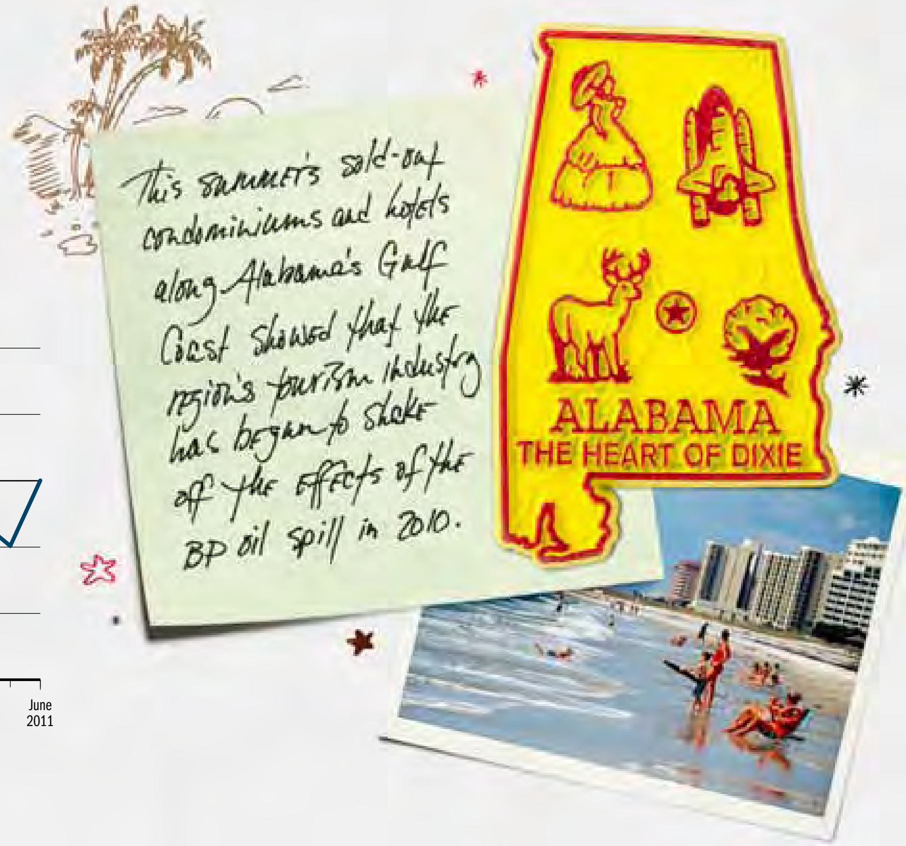
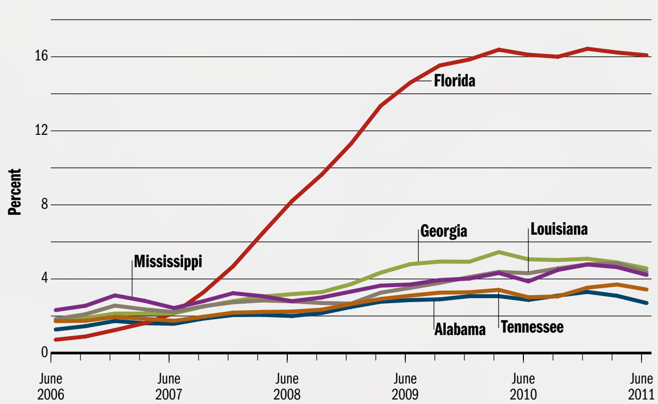


Chart 9
Percent of Mortgage Loans in Foreclosure



Note: Data are through second quarter 2011.
Source: Mortgage Bankers Association, Haver Analytics

levels and that shipments of chemical and agricultural goods, in particular, remained steady. Rail contacts noted that deliveries of energy- and food-related products drove increased activity.

Chris Oakley, the regional executive in the Atlanta Fed's Jacksonville Branch and chair of the Bank's Trade and Transportation Advisory Council, reported on the council's October meeting: "In contrast to the meeting in April 2011, Trade and Transportation Council members reported that demand was flat across most industries in the transportation sector. Members are not anticipating much in the way of a seasonal spike in shipping for the 2011 holidays."

The pricing environment continued to pressure bottom lines, according to Oakley. "Softening of fuel prices has reduced fuel surcharges, but carriers had little success in raising base rates to increase margins."

Loan growth remains tepid

Weakness in real estate has also had an impact on the region's financial institutions. While area banks' balance sheets continued to heal, contacts in the financial community indicated persistently weak loan demand. Loan growth remains a concern for banks across the Southeast. Lending levels continued their decline during the first half of the year as new opportunities remained highly elusive, but those declines appear to be shrinking (see chart 8).

Deposits increased as people and businesses boosted savings in 2011. The majority of large firms continued to have ready access to cash and lines of credit while some small firms and many new firms seeking credit experienced difficulty. Some nonbank entities, such as private equity firms and groups of wealthy individuals, reportedly became increasingly involved in small business lending. Mortgage foreclosures in the region remain elevated, with Florida having one of the highest foreclosure rates in the nation (see chart 9).

Where it all comes together: The labor market

The impact of everything discussed up to this point is apparent in the region's labor markets. Atlanta Fed President Dennis Lockhart spoke about jobs in September in Jacksonville, Florida,

Governments Also Tightening Belts

In April 2011, Federal Reserve Bank of Atlanta President Dennis Lockhart spoke in West Palm Beach, Florida, about the current phase of American economic history, which he termed the "Great Rebalancing." President Lockhart sees three rebalancing processes now under way: rebalancing of consumption and savings, regulatory rebalancing, and fiscal rebalancing. With regard to the last process, he noted then that "spending cuts have begun at all government levels, and some improvement in revenues is now being reported."

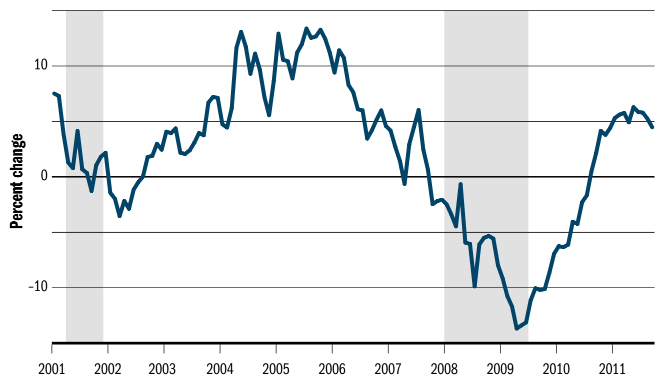
As President Lockhart noted, it is too early to determine the outcome of overall fiscal rebalancing at the national level, or even the state level. Public sector employment at the state and local levels can provide one clue as to where some of this rebalancing will occur. In southeastern states, weakness has certainly been evident. Over the summer months of 2011, total net government employment declined by 37,500 jobs.

With regard to revenues, the data are a bit more positive. Looking at the southeastern states, revenues in the third quarter of 2011 are nearly 4.5 percent higher than in the same period in 2010 (see the chart).

A recent report by the Nelson A. Rockefeller Institute of Government, written by senior policy analyst Lucy Dadayan and senior fellow Donald Boyd, confirmed that "after the deepest recession since the Great Depression, most states are now on the gradual road to tax revenue recovery."

President Lockhart's view that further fiscal rebalancing lies mostly ahead of us is confirmed by the Rockefeller Institute

Southeastern States Governments' Total Tax Revenues



Notes: Data are based on a three-month moving average and are through September 2011.
Sources: Georgia, Florida, Alabama, Tennessee, Louisiana, and Mississippi departments of revenue

authors. They include a cautionary note: "Broad state fiscal conditions remain fragile. The longer-term outlook is still ominous due to factors such as record revenue declines during the Great Recession, spending trendlines still pointing upward, and unemployment rates remaining nearly double their prerecession levels, to name a few. While some economic indicators signal improvement in overall conditions, fiscal recovery for the states typically lags a national turnaround and is likely to take several years." ∎

remarking: "In terms of job creation, we appear to be treading water. Basically, the weak pace of growth in output since the end of the recession has translated to only modest net job creation. Modest gains in the private sector have been partially offset by ongoing losses in the public sector.

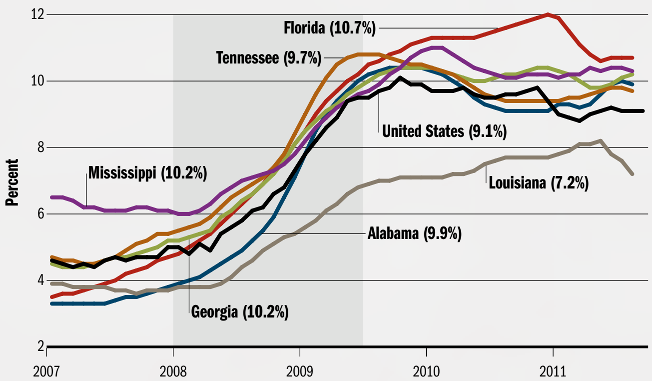
"As a result, there has been little progress in bringing down the high rate of unemployment," he added. "The unemployment rate would be even higher if it weren't for the fact that some people are dropping out of the labor market completely.

"I think it's most realistic to expect only a gradual improvement in the unemployment rate, consistent with the subdued growth trajectory for output and spending."

While President Lockhart was speaking broadly about the national economy, his words apply equally to the region. The only difference is that labor market conditions here are somewhat worse than in the nation as a whole. Unemployment rates in every southeastern state except Louisiana remained above the U.S. unemployment rate in 2011 (see chart 10).

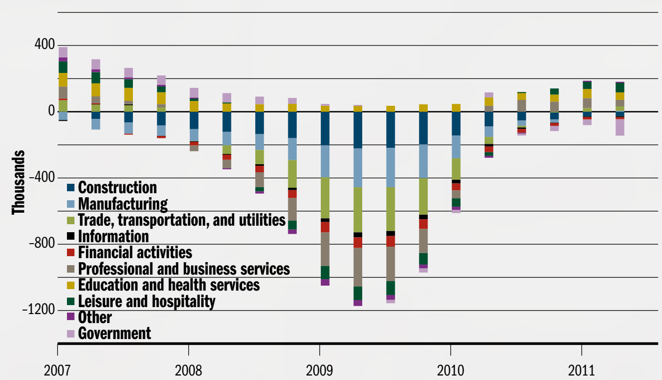
Job growth has been anemic throughout the region. Sectors that contributed positively to employment growth in southeastern states prior to the recession have not fully recovered. Employment in trade, transportation, and utilities stands out in this regard. Jobs were hit hard in this sector during the recession, and payroll gains in the last two quarters have been modest. Moreover, these gains are lower than the increases in payrolls prior to the recession, further evidence of a weak recovery. Professional and business services as well as leisure and hospitality payrolls had a similar experience during the recession, but recovery has been more robust in these sectors. Worrisome employment trends in manufacturing and construction, which

Chart 10
Unemployment Rates



Notes: Data are through September 2011 and are seasonally adjusted. Numbers in parentheses are states' unemployment rates as of September 2011.
Source: U.S. Bureau of Labor Statistics

Chart 11
Employment Changes by Sector in Southeastern States



Notes: Data are calculated year over year by quarter, are not seasonally adjusted, and are through second quarter 2011.
Source: U.S. Bureau of Labor Statistics

began prior to the recession, were exacerbated by the downturn. While these declines have eased in the last two quarters, significant employment increases haven't occurred.

Education and health services offer a glimmer of hope for sustained job growth in the region. Even during the recession, southeastern states added payrolls in this sector, and the positive trend continued well into 2011.

As a whole, the private sector in southeastern states has experienced only a modest recovery (see the sidebar on small business). In recent quarters, declines in government payrolls have pressured the already shaky recovery. However, the region has gained jobs overall since the second quarter of 2010, and most of the job losses since then have come from cuts in government payrolls (see chart 11 and the sidebar on government finances).

When asked about their take on these labor market dynamics, Atlanta Fed business contacts agreed that there was indeed little hiring taking place across much of the region. Employers are clearly managing their labor supply very tightly.

Firms indicated that they are relying on their permanent employees to maintain the company's core business, while focusing a significant contingent workforce (made up of, for example, temporary employees) on specific projects and, in some isolated cases, growth-oriented efforts. Temporary employees continued to fill short-term openings, and several contacts reported screening potential permanent hires by first hiring them as temps. A few reports emerged of businesses still seeking to maximize productivity gains from current employees. Several employers also reported achieving efficiency gains as firms increased investment in technology.

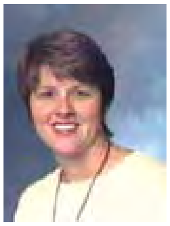
Hiring agencies across much of the Southeast noted difficulty finding qualified applicants for specialized positions, possibly because of "house lock," or the inability to relocate because of the difficulty in selling a house. "'House lock' has been a factor when recruiting for higher-level positions," said Denise McLeod, vice president and chief operating officer of Landrum Staffing Services Inc. in Pensacola, Florida, and a member of the Atlanta Fed's Labor, Education, and Health Advisory Council. "The unknown factor is how many qualified individuals never make the first contact regarding a position opening that requires relocation. In other cases, we've seen families maintain their current household while the spouse moves to a new location and position and rents or leases minimal housing space. Clearly, family dynamics take a hit in this undesirable situation."

A significant characteristic of the current expansion is the number of long-term unemployed seeking employment. Of people unemployed in September 2011, 44.6 percent of them have been without employment for 27 weeks or more. Exacerbating their woes are businesses that have indicated they were less inclined to tap into the unemployed labor pool but were actively recruiting currently employed workers. McLeod explained, "Hiring authorities shy away from the long-term unemployed for several reasons. Many disclose concerns regarding skill gaps as a result of workforce inactivity, while others are concerned about diminished motivation and soft skills. Often, concern about a candidate's stated lack of adaptability after being unemployed for a long period supports their reasoning for avoiding the long-term unemployed."

What the Atlanta Fed hears about inflation

Full employment is half of the Fed's dual mandate, and price stability is the other half. President Lockhart spoke on this topic in Atlanta in late November. "Inflation moderated in the third

"Harvest of Most Crops Has Remained on Track"



An interview with Lesley McClure, regional executive of the Birmingham Branch and chair of the Atlanta Fed's Agriculture Advisory Council

EconSouth: *Lesley, as the regional executive from the Atlanta Fed's Birmingham Branch, you chair the Atlanta Fed's Agriculture Advisory Council. Can you share some insight into the group's latest meeting?*
Lesley McClure: Sure. We met in early October and focused our discussion on the overall environment regarding agriculture in the region—production, investment, and prices in particular—and we spent some time talking labor issues. Farm produce has been affected in some areas by drought, most notably in Georgia and Alabama, but overall harvest of most crops has remained on track. We also heard that demand for many U.S. products is driven by two factors: increased demand in China and the emergence of Brazil as a major agricultural exporter. Despite competition from Brazil, Florida citrus producers expect solid returns this growing season, but there are continuing concerns over plant disease and pest issues. Our council members also indicated that they are seeing the biggest investments they have seen in many years in both land and equipment.

ES: *With farm producers experiencing solid demand, prices must be holding up well for regional farmers.*
LM: Yes. Many council members noted increases in input prices as well as prices they receive for product, although there was mention of very recent price decreases for some agricultural products and the impact of the rising value of the dollar in September negatively affecting exports. On input pricing, one member noted that suppliers are quick to increase prices but slow to decrease when the commodity price drops. The particular example was fuel.

ES: *The Southeast has received some attention as a center for biofuel development because of our abundance of timberland. What was the council's read on the timber sector?*
LM: The timber industry is doing well in pulp and pellets [biofuel], but the lumber portion of the industry, and the sod industry, is not doing well as the residential construction industry is still down. Although China has been importing American timber, recently these orders have fallen off. Lots of timber-related mills are closing or being consolidated, which may affect future ability to produce timber products when the market comes back.

ES: *Georgia and Alabama recently enacted immigration laws. What do your council members say about the impact of these laws on agricultural employment?*
LM: This issue was discussed at length. We heard that it has become increasingly difficult to find farm workers, which is putting strain on not only the agriculture industry, but other industries as well: leisure and hospitality, for example. Row crops, citrus, and poultry were specifically mentioned as agricultural products in danger of suffering potential losses because of a lack of workers to harvest. ∎

quarter, in large part as the influence of gasoline and other commodity costs retreated from earlier in the year," he said. "Other cost pressures, including labor compensation, remain subdued, and inflation expectations are holding steady. In other words, the underlying sources that drive inflation appear to be in check.

"My baseline forecast for 2012 builds on the picture I've just painted of the second half of 2011," he added. "I'm expecting continued moderate growth, decently behaved inflation, continuing net job creation, but slow progress on unemployment."

Most contacts in the Southeast reported input prices had receded in the third quarter after rising in the first half of the year. An informal poll of the Federal Reserve Bank of Atlanta's board of directors and their business contacts during the summer of 2011 revealed that 62 percent expected prices they charge for goods and services to remain the same, 30 percent planned to increase prices, and only 8 percent were planning to decrease prices over the next three to six months.

Many regional retail contacts noted plans to attempt to raise prices, but with an understanding that any increases would likely be retracted if customers pushed back. Retailers continue to discount products aggressively to draw in traffic and have found it difficult to end such practices out of concern over losing customers. Accordingly, margins remained squeezed through the close of 2011, and greater efficiency and cost-cutting continue to be areas of focus for businesses in the region.

On the other hand, manufacturing (including food producers) and energy firms have been successful over the year in passing on raw material price increases to their customers (see the sidebar on agriculture). Throughout 2011, retailers of luxury goods have also reported success in passing through higher input costs to their customers, whereas midmarket and lower-end retailers have not been as successful.

With a couple of exceptions, mostly limited to specialized computer technology and health care positions, 2011 ended with little pressure on wages. Several contacts noted relief among staff who have retained their positions during the downturn, even in an environment of flat or declining wages and benefits. Many contacts noted longer-term concern over the rising cost of health care benefits.

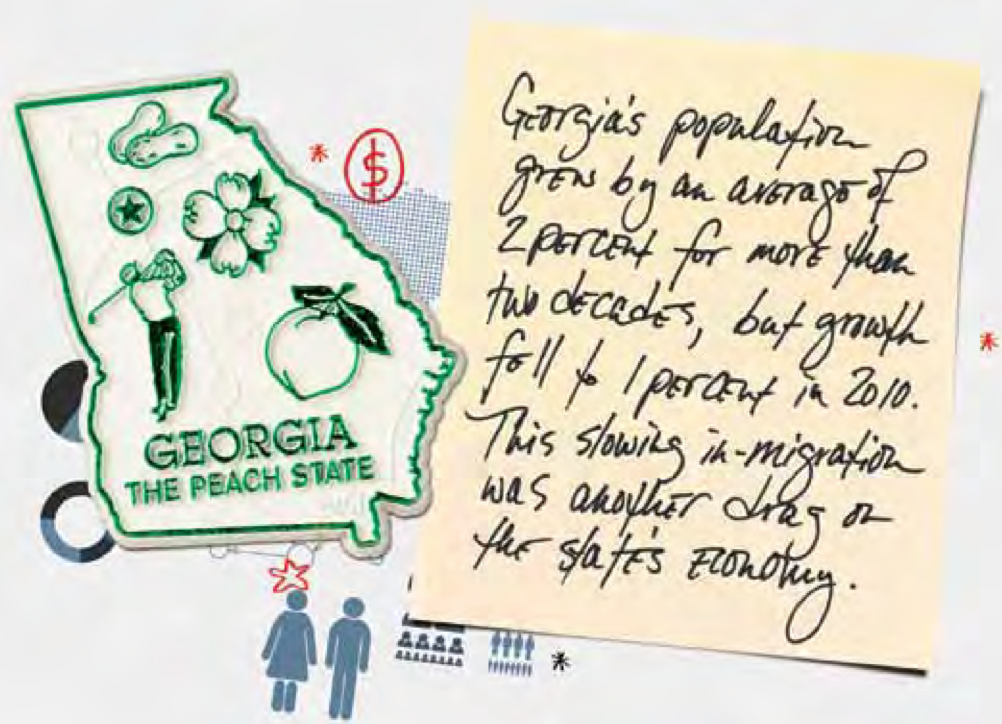
Looking ahead to 2012

As 2011 came to a close, the majority of Atlanta Fed directors and business contacts in the Southeast described economic activity as moving forward, albeit at a slow pace. The Atlanta Fed's October poll of director sentiment regarding the outlook for economic activity showed that 58 percent expect no change, 29 percent anticipate higher activity, and 13 percent see slower activity six months out. More broadly, even in the midst of this rather sedate outlook, no sign of panic or despair was apparent, which may indicate that expectations for 2012 are not overly negative.

President Lockhart's outlook for the national economy "calls for gross domestic product (GDP) growth in the 1 to 2 percent range for this year [2011], moving up to a range of 2 to 3 percent next year [2012]. In full disclosure, this forecast is lower than my staff and I projected at the beginning of the summer. Following official revisions to earlier growth estimates and because of weaker-than-expected incoming data more recently, we revised down our growth forecast."

Barring unforeseen shocks, economic activity in the Southeast is expected to improve in 2012. But, with in-migration stalled, there is only a small likelihood that the region will regain in 2012 the solid expansion levels seen before the recession. And, while the region is expected to see positive net job creation in 2012, the pace will probably be too slow to make a significant or rapid dent in the high unemployment rates seen in 2011. ∎

This article was written by Michael Chriszt, an assistant vice president in the Atlanta Fed's research department. Mark Carter, Neil Desai, Pam Frisbee, Whitney Mancuso, Shalini Patel, and Ellyn Terry, analysts in the Atlanta Fed's research department, also contributed.



Shocks Unbalance the Global Economy

A number of shocks slowed the global economic recovery in 2011. Emerging economies on the whole fared better than the advanced economies, but the interconnectedness of the global economy and financial markets did not leave them unscathed. Economists are looking to moderate growth in 2012, but their fairly optimistic forecast hinges on the resolution of the European debt crisis and the political fiscal impasse in the United States.

As 2010 drew to an end, economic forecasters were predicting continued robust expansion into 2011 for the global economy. Sizeable macroeconomic stimulus packages in most parts of the world had boosted much of the growth throughout the year, but policymakers were hoping that as fiscal support faded, private demand would strengthen enough to carry the expansion forward. Although economists at the time acknowledged a number of downside risks, such as possible return of financial stresses in fiscally weak countries in the euro area, the baseline scenario was of sustained solid growth in advanced economies and a strong expansion in emerging countries.

But soon after 2011 began, the global economy began to experience a number of shocks, and global expansion slowed. Growth in advanced economies weakened markedly. The emerging economies as a group fared better, but given the interconnectedness of the global economy and financial markets, their growth momentum also waned as economic activity decelerated across the advanced economies.

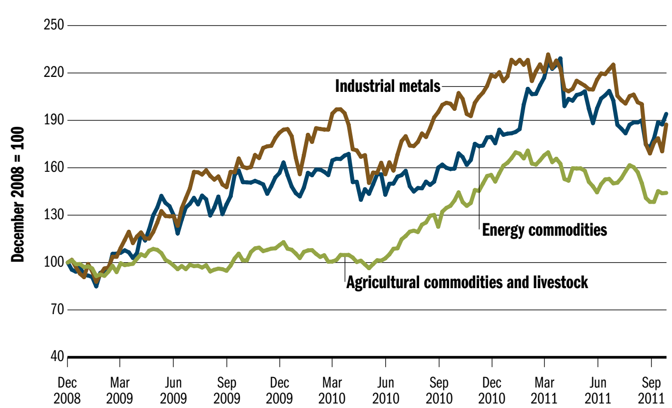
Civil unrest, natural disaster unsettle the world economy

In the early weeks of 2011, civil unrest spread through a number of countries in the Middle East and North Africa—a region that is also a key global supplier of oil. Resulting concerns over oil supplies sent oil prices sharply higher. In addition, prices of many other commodities, including agricultural commodities, had been increasing in tandem with continued economic growth (see chart 1). Both food and gasoline became significantly more expensive, fanning inflationary pressures and reducing consumer spending on more discretionary items.

Then, in March, natural disaster struck Japan. A massive earthquake followed by a tsunami ravaged the northeastern part of the country, leaving human tragedy and vast property damage in their wake. Japan is a major supplier of products and parts to factories the world over, so the disruption in Japan's manufacturing capability caused production around the globe to stutter. Some experts estimate that global automotive production, for example, fell by about 30 percent in the two months following the earthquake. Overall, the interruption in the supply chain may have shaved off as much as half a percentage point from world economic growth in the second quarter.

As the second quarter closed, renewed concerns about sovereign debt in a number of euro zone countries began to roil global financial markets. The sovereign debt crisis first broke out in Greece in 2010, but the response of European policymakers at the time helped limit its impact on the global economy. Economists and other observers assumed that the negative financial and economic effects of the necessary fiscal adjustment would be contained to the so-called "peripheral" European countries—Greece, Ireland, Portugal, Spain, and Italy. However, the sovereign debt problems in Europe proved to be much deeper and more contagious.

Chart 1
Commodity Prices



Note: Data are through October 2011.
Source: Standard and Poor's/Haver Analytics

International Trade Shores Up U.S. Economy

International trade continues to play an important part in the U.S. economy. Exports in particular have contributed significantly to the economic recovery. Healthy economic expansion in most of our major trading partners has generated solid foreign demand for U.S. goods and services. U.S. exports to fast-growing emerging economies, such as China, have been particularly strong. In addition, the depreciation of the dollar has made U.S. exporters more competitive in international markets. Capital goods, auto products, industrial supplies, and services have been the largest contributors to recent export growth.

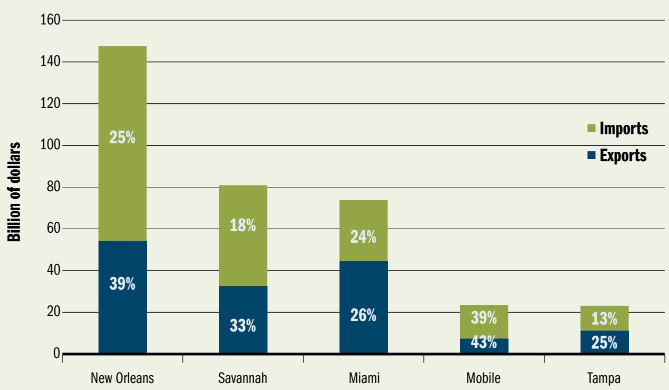
Imports, which fell sharply during the recession, have also increased as consumer spending and business investment recovered in the United States, with capital goods, autos, and auto parts leading overall import growth after the recession. Notably, consumer goods (except autos) accounted for less than one-fifth of the total increase, which is significantly less than in the decade prior to the recession. Overall, the U.S. trade deficit has widened since mid-2009, as our imports continue to exceed exports.


Mobile, Alabama's port

In the first half of 2011, both exports and imports increased steadily, although trade growth decelerated when the global economy lost some momentum. Data from southeastern ports confirm this growth. Year to date, all port districts in the region saw double-digit increases in both exports and imports by value compared to the same period in 2010 (see the chart). Trade growth was especially robust in the Mobile, Alabama, port district, with increases in the prices and shipments of coal, pulp products, and steel accounting for a big part of that growth. The Mobile port also benefited from rising production and shipments from a major steel manufacturer that moved to the area.

International trade is likely to contribute to U.S. economic growth in 2012. Economic forecasts call for exports to continue increasing, largely because of the continued demand for U.S. products from emerging economies. Meanwhile, import growth will probably remain subdued, in line with expected softness in domestic spending. ∎

Trade Values by Port District



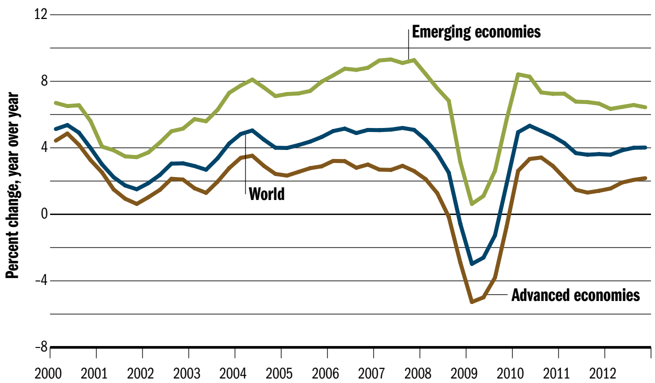
Note: Data are through August 2011. Percentages indicate growth in 2011 over 2010.
Source: U.S. Census Bureau/Haver Analytics

Sovereign debt problems persist in peripheral Europe

After Greece's rescue by the European Union and the International Monetary Fund, Ireland and Portugal also asked for international assistance when borrowing in financial markets became cost-prohibitive. All three countries received large financial packages, equal to about 45 percent of their gross domestic products and enough to cover most of their governments' financing needs for three years.

Over this past summer, however, investors became increasingly concerned about the ability of Italy and Spain—the third- and fourth-largest economies in the euro area—to pay their sovereign debts. As worries about the fiscal sustainability of these two countries increased, global financial markets became more volatile and stock prices moved sharply lower. Investor anxiety about sovereign defaults then hit the euro area's banking sector. Markets became more and more concerned about the exposure

Chart 2
2012 Global Outlook



Source: International Monetary Fund, *World Economic Outlook, September 2011: Slowing Growth, Rising Risks*

of European banks, including those in France and Germany, to the peripheral countries' sovereign debt problems. Stock prices of the largest French banks fell to levels not seen since early 2009. European banks began to face acute funding pressures. Given the European economy's reliance on bank lending, escalating problems in the banking sector became a major risk to the region's economic recovery. Significantly, the banking sector is a major channel through which European woes could be transmitted to other parts of the world, including the United States.

European policymakers had to mobilize larger and larger official financial resources to calm the markets, and the European Central Bank (ECB) did its share to support the banking sector. The ECB provided liquidity, bought sovereign debt, and supplied dollar funding to European banks by using a swap line with the Federal Reserve. Without a doubt, much of the financial market volatility was directly linked to investors' perception of the effectiveness of the various measures the policymakers took to arrest the crisis.

Governments in the peripheral countries committed to multiyear austerity plans that include drastically reducing public spending and increasing some taxes to reduce their nations' deficits and bring down debt burdens. They also announced structural reforms, such as pension and labor reforms, to promote long-term growth and fiscal sustainability. All of these countries, which represent a large part of Europe's economy, are facing several years of fiscal and structural adjustments and weakened growth prospects.

The sovereign debt crisis in Europe severely undermined consumer and business confidence and put a brake on economic growth in the region. Even in Germany, which has been the euro area's growth leader since the end of the recession in 2009, economic recovery lost momentum.

Financial markets transmitted European uncertainty to other parts of the world, including the United States, dragging down consumer and business confidence here as well. Furthermore, the lack of political consensus around fiscal adjustment plans in the United States has also weighed on confidence here.

Emerging economies remain resilient

The disruptions of the advanced economies did not affect the emerging economies to the extent that they have in the past. Although the increased global uncertainty caused capital flows to emerging countries to reverse somewhat and also weakened Western demand for their exports, domestic demand in emerging countries was relatively strong (see the sidebar). The emerging economies' resilience is explainable in part by East Asia's rising power. The region's economy is now large and dynamic enough to generate sizable import demand for foreign products. China in particular supported economic growth in Latin America, for

China's appetite for commodities such as oil resulted in growth in exports from resource-rich countries.

example, by importing a wide range of raw materials and other commodities that the region produces. In addition, China is an important investor in many developing countries, especially in Latin America and Africa.

In fact, in contrast to the anemic expansion in advanced economies, economic growth in emerging countries was strong enough in 2011 to generate concerns about potential overheating. Furthermore, emerging countries experienced substantial inflationary pressures from the rising price of food, which in these countries represents a big part of consumer spending. Many parts of the emerging world tightened monetary policy as a result of these pressures. However, as the global environment became more uncertain, central banks in many emerging economies either paused or actually began to reverse earlier rate hikes to support their economies.

The look ahead is uncertain

The global economy is expected to expand in 2012, although the pace of growth is likely to continue to differ substantially across regions. Emerging countries, which now account for about 40 percent of global consumption and two-thirds of global growth, are expected to maintain their strong growth trends. Some deceleration may occur, however, if external demand weakens enough. Eastern Europe, in part because of its trade links to Western Europe, is particularly vulnerable to the downturn in the euro area. Many emerging countries have room to offset declines in external demand with more stimulative macroeconomic policies.

Advanced economies, on the other hand, are facing weak growth and cannot rely solely on fiscal or monetary policies to turn their fortunes around. Policy interest rates are already close to zero in many countries and, with very weak fiscal positions, governments have no more appetite for fiscal stimulus. High unemployment, weak income growth, and still-depressed housing markets in many of those countries—including the United States—are likely to continue to weigh on consumer confidence and willingness to spend. On the positive side, economists expect inflationary pressures to subside as commodity prices level off. In addition, business investment is likely to remain strong, and demand from emerging markets should support the advanced economies' exporters.

The International Monetary Fund's September forecast for 2012 predicted an expansion in the global economy at a 4 percent pace—close to its 2011 growth pace. Emerging countries are expected to grow at about 6 percent, while advanced economies are likely to expand at a much smaller 2 percent (see chart 2 on page 25).

This fairly optimistic outlook is very uncertain and subject to considerable downside risks. The biggest of those risks are the continued severe financial stress in Europe and political impasse over fiscal consolidation in the United States. Continued political stalemate in the United States over the fiscal situation may lead to more loss of consumer and business confidence, which in turn could further undercut economic activity. Other notable risks are potential credit and real estate bubbles in some emerging countries and a possible run-up in world commodity prices because of tight supply-demand balance for a number of major commodities. ∎

This article was written by Galina Alexeenko, director, Regional Economic Information Network.

CONTINUED FROM PAGE 1

inherently small-scale or mom-and-pop firms—that are the true drivers of job creation. About 40 percent of new jobs in a given year come from the fastest-growing 1 percent of businesses, according to a 2010 Kauffman Foundation study. Three-quarters of those high-growth businesses are less than five years old.

One source of new jobs, then, is scalable-growth businesses that often aim to commercialize innovation. Scalable start-ups need capital. As mentioned above, banks supply some but hardly the bulk of that capital. Banks' historic reluctance to finance start-ups generally is understandable, given that banks need to make loans with a very high probability of repayment. Start-ups by nature lack any record of repayment. This is why most entrepreneurs turn elsewhere. While the most common source of start-up capital was personal saving, also important was personal bank credit, including home equity loans and credit cards, according to the Census Bureau survey.

The reality is that banks have not traditionally been the primary financial backers of start-up companies.

Only 19 percent of owners of firms said they started their businesses with a bank loan, according to the survey. That number could be even lower today, as banks in recent years have reduced their direct financing of start-ups. A 2011 Atlanta Fed poll found that Southeast businesses less than six years old were much less likely to have used a bank loan when they started than were older firms, and were more likely to have relied on personal savings.

The Census Bureau findings may help explain some of the decline in new business formation during the recession. Home equity lines, for example, are more difficult to obtain because of falling residential real estate values since 2007. Home equity lines haven't been the only pool of start-up capital to have shrunk—both the number of credit card accounts and limits on these accounts are well below prerecession levels, according to the third quarter edition of the New York Fed's *Quarterly Report on Household Debt and Credit*.

We need more start-up activity

Through good times and bad, the U.S. economy constantly creates new businesses and jobs while destroying other businesses and jobs. The problem today is that the balance of creation and destruction has tilted negatively because of a slowdown in new business formations. The number of new business establishments peaked at about 870,000 in 2006, then fell to 700,000 in 2009, and reached 720,000 in 2010, according to the U.S. Bureau of Labor Statistics.

From 1992 to 2005, more businesses were formed than closed, so the total number of establishments increased over time. That dynamic has since reversed. Bank credit constraints, however, are not a primary reason for that reversal.

Clearly, many of the traditional sources of funding have shrunk. How, then, do we channel capital to start-ups and early-stage enterprises in the interest of job creation?

There are no simple answers to this question. Capital formation for scalable start-ups and early-stage businesses is a serious challenge for both the private sector and public policymakers.

Still, it's clear that we need more activity in the start-up sector of our economy. While it is tempting to look to the commercial banking sector to stimulate start-up activity, that view is too narrow. To begin formulating ideas that can revive this sector and thereby create more jobs, we must first have a practical grasp on commercial reality, including the role of banks. ∎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closing numbers

4

Predicted expansion, in percent, of the global economy in 2012

Source: International Monetary Fund, as cited in *EconSouth*'s article, "Shocks Unbalance the Global Economy"

389

Number, in millions, of Internet users in China, the world's highest, compared with 245 million U.S. users

Source: Central Intelligence Agency *World Factbook*

18

Increase, in percent, of Florida condominium sales in September 2011 compared with September 2010

Source: Florida Realtors Association, as cited in *EconSouth*'s article, "The Southeast Struggles to Recover"

15,079

Number of airports in the United States

Source: Federal Aviation Administration

138

Number, in millions, of U.S. nonfarm jobs in January 2008, the peak of employment

Source: U.S. Bureau of Labor Statistics, as cited in *EconSouth*'s article, "2011's Reluctant Recovery: Breaking Through in 2012?"

8.1

Number, in millions, of U.S. adults who were victims of identity fraud in 2010

Source: Javelin Strategy & Research

$7,605

Amount of one year's average college tuition and fees at a four-year public institution for in-state students in the 2010–11 school year, up 7.9 percent from the previous year

Source: The College Board, *Trends in Pricing 2010*

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What a difference a year makes! Gulf Coast tourism was hit hard by 2010's oil spill in the Gulf of Mexico, typified by this scene in Pensacola, Florida (top). Vitality returned to the Gulf Coast's tourism industry in summer 2011, as vacationers once again flocked to Pensacola's beaches (bottom).

now and then