Although the national recession ended in the summer of 2009, the recovery in the Fifth District did not truly begin until 2010.

The rebound was not as strong as might have been expected coming out of such a severe downturn, but the recovery that took hold in 2010 provided an overall expansion in jobs and a definite improvement in business conditions by the end of the year. Still, the District economy remained weak during the year, as labor markets struggled to regain the losses of the previous two years and the real estate sector continued to be a drag on the economic recovery.

Labor Market Conditions

Fifth District labor markets bottomed in 2009, and employment losses moderated throughout the second half of that year, but 2010 marked the beginning of solid job growth. By the end of December the District had added 65,100 net jobs to the economy. Most of the year-over-year job gains in the District were in the professional and business services sector, although the trade, transportation, and utilities sector and the education and health services sector also contributed notably to the employment gain. A number of industries reported net job losses in 2010, including manufacturing, information, financial activities, and natural resources and construction, but the sharpest absolute and percentage decline was in the government sector.

Despite the steady job growth, the Fifth District gained back only a fraction (8.6 percent) of the more than 750,000 jobs lost over the course of the economic downturn. The District performed slightly worse than the United States as a whole, which lost more than 8.5 million jobs during 2008 and 2009 and gained back approximately 1 million jobs (10.9 percent) in 2010. By December 2010, 1.2 million Fifth District residents were still unemployed. The District unemployment rate peaked at 9.4 percent in February and March 2010, though it fell to 8.6 percent by the end of the year. By this measure, the District outperformed the nation, which ended the year with 9.4 percent unemployment.

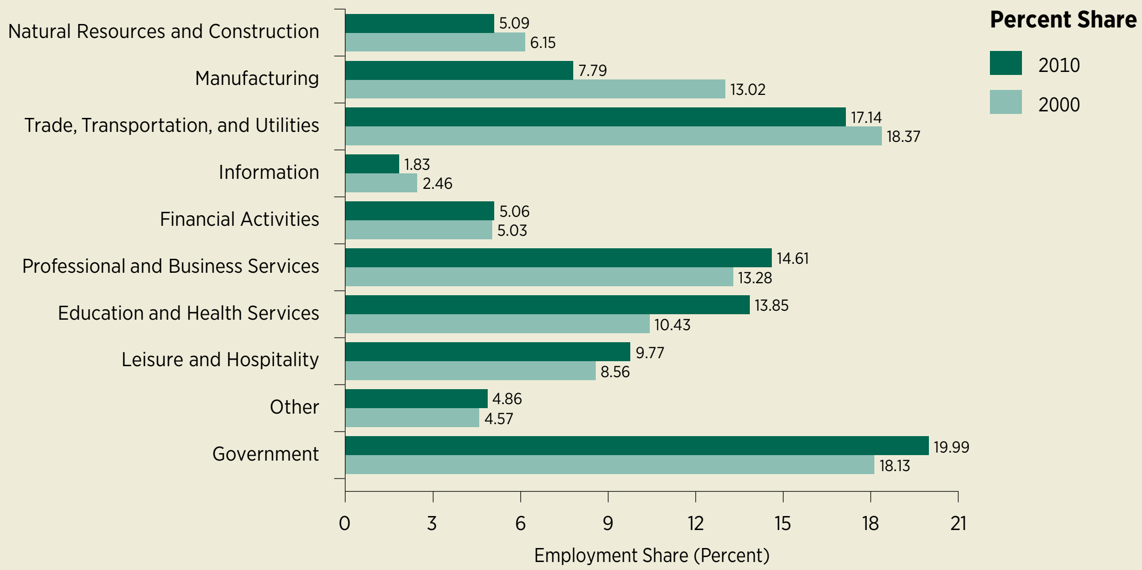
The recession was deep, but does not seem to have initiated any long-term structural change in District labor markets. Nonetheless, the downturn might have accelerated some existing structural trends. For example, employment in manufacturing fell from 8.9 percent as a share of all District employment in December 2007 to 7.8 percent in December 2010, but the decline continued an earlier trend; in December 2000, manufacturing accounted for 12.8 percent of employment. Conversely, education and health services rose from 10.5 percent of District employment in December 2000 to 12.6 percent in December 2007, and to almost 14 percent by December 2010. Overall, the District's goods-producing sector is steadily accounting for less and less of the region's employment and output.

One industry change was clearly brought on by the recession: the reduction in natural resources and construction employment. This industry grew in the early 2000s, but lost more than 200,000 jobs in 2008 and 2009, and another 16,000 jobs in 2010. From the end of 2007 to the end of 2010, the natural resources and construction industry's contribution to District employment fell from 6.1 percent to 4.7 percent, due at least in part to the recession's effect on housing and commercial real estate markets.

The recession played out differently in different areas of the Fifth District. The northern part—roughly

FIGURE 1

Fifth District Industry Share of Employment (Annual Averages)



Sources: Bureau of Labor Statistics, Haver Analytics

the District of Columbia, Maryland, and much of Virginia—suffered a housing downturn that spilled into labor markets starting at the end of 2008 and continuing into 2009. In North and South Carolina, however, the labor market downturn generally preceded the decline in house prices and the rise in foreclosure activity, and employment conditions remain weaker in these states. Together, Maryland and Virginia lost around 260,000 jobs in 2008 and 2009, accounting for 34 percent of the jobs lost in the Fifth District, while North and South Carolina shed more than 480,000 jobs, or 63 percent of all District job losses. The District of Columbia economy actually added jobs, on net, during 2008 and 2009, and in 2010 it contributed more than 15 percent of Fifth District job gains. Maryland and Virginia together contributed 35 percent of the employment increase in 2010, while North and South Carolina accounted for about 44 percent of job gains. West Virginia, meanwhile, contributed about 2.5 percent of losses in 2008 and 2009 and 5 percent of the rise in 2010. In other words, while labor market conditions remain challenging across the Fifth District (and the nation), the southern part of the District seems to have a more difficult road ahead; by adding 29,000 jobs in 2010, North and South Carolina have made only a small dent in replacing the jobs lost in 2008 and 2009.

Unemployment rates in District states remained high, but began to come down in 2010. The Virginia unemployment rate—which was the lowest in the District throughout 2010—ended the year at 6.6 percent, 0.6 percentage point below its December 2009 mark. The Maryland rate ended the year at 7.4 percent, a rate that held for more than half of 2010. In North Carolina, the jobless rate peaked at 11.4 percent in January and February, but fell to 9.8 percent by December. In South Carolina, the rate fell from a peak of 11.8 percent in December 2009 to 10.9 percent in December 2010, although it remained one of the highest rates in the country. West Virginia was the only Fifth District jurisdiction to see the unemployment rate rise in 2010—from 8.7 percent in January to 9.7 percent in December 2010.

Residential and Commercial Real Estate Conditions

The housing sector remained arguably the biggest drag on the Fifth District and national economies in 2010. The first-time homebuyer tax credit helped to spur sales in the first part of the year, particularly for middle- or lower-priced homes. Sales fell again in the second half of the year, although there was some indication of firming housing conditions toward the very end of 2010. Foreclosure and short-sale activity expanded throughout the year, but at the other end of the spectrum, high-priced and luxury home sales remained extremely slow. According to the National Association of Realtors, existing home sales fell in the first quarter of 2010, expanded in the second, dropped again in the third, and rose again in the fourth quarter throughout the District. (The one exception was Virginia, where existing home sales fell further in the fourth quarter.) Despite the volatility of home sales, however, 2010 sales activity was at least somewhat improved from the steep decline that began in 2007.

The house price declines of recent years abated across Fifth District states in 2010, but house price movements were still volatile. Prices fell slightly in the first and second quarters of 2010, picked up—for the first time in years—in the third quarter, but then dropped again in the fourth quarter in every District state except West Virginia. Nonetheless, the moderating decline, or even slight improvement, in certain housing market indicators helped to stem the rise of distressed homeowners across the District. The number of homeowners with mortgage payments more than 90 days past due remained the same or fell in every quarter of the year in every District state, with the exception of a slight rise in 90-day-plus delinquencies in Maryland in the third quarter. The foreclosure news was a little more mixed. Although most states experienced some declines in foreclosure inventory rates, fourth quarter rates rose across the board, and foreclosure starts rose slightly in the District of Columbia, Maryland, and Virginia.

Despite spotty reports of improved vacancy rates or leasing activity, commercial real estate remained weak in 2010. Even those developers that reported improvement continued to cite generally soft conditions, little new construction, and persistent downward pressure on rental prices.

Business Conditions

In the early part of 2010, U.S. and Fifth District businesses faced economic and policy uncertainty, which, combined with an unexpectedly sluggish recovery in consumer spending, made investment and expansion difficult to consider. As the year continued, however, optimism grew among both consumers and area businesses, and business conditions strengthened notably by the end of the year.

The steady pickup in both foreign and domestic demand throughout 2010 supported an improvement in conditions among District manufacturers. The Richmond Fed's survey of manufacturing indicated notable recovery in District shipments and new orders throughout the year, as well as improved employment conditions. Activity at District ports was stronger in 2010 than in 2009, and export activity continued to expand across much of the District throughout the year.

The service sector recovered at a more modest pace. Both retail and services firm activity was subdued by low consumer spending through much of 2010. Nonetheless, conditions improved over the year, and the Richmond Fed's survey on service sector activity revealed recovery in services firm revenues by the end of the year. Revenues among retail firms remained somewhat depressed, although declines in 2010 were considerably more moderate than in 2009. Both retail shopper traffic and sales of big-ticket items were slow throughout the year.

Banking Conditions

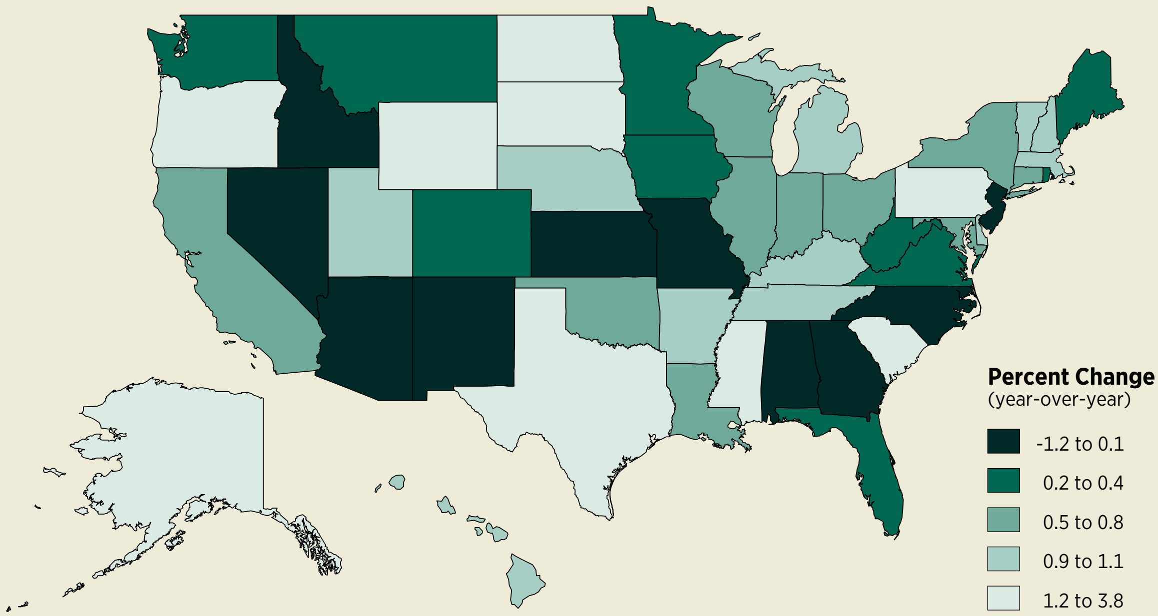
Banks nationwide and in the Fifth District remained challenged during 2010 as they continued to address problem assets. There were signs that the pace of deterioration slowed in 2010. A closer look at the data reveals a tale of two banks. With a diversified business, large banking organizations were able to recognize losses and restructure their balance sheets early in the credit cycle. In contrast, community banks (defined as having assets less than $1 billion) are experiencing a lag in problem assets nationwide and in the District. The lag is most noticeable at community banks with heavy concentrations in commercial real estate (CRE) and that are located in areas experiencing a slower economic recovery.

Given the slow recovery of the housing market, the closely related CRE category of construction and land development experienced particularly high default rates. On average, District community banks had taken

FIGURE 2

Change in Payroll Employment

December 2009 – December 2010



Sources: Bureau of Labor Statistics, Haver Analytics

on high relative exposures to CRE, resulting in overall poorer performance during this credit cycle relative to the nation. Credit quality statistics for Fifth District community banks continued to deteriorate during 2010 with median net charge-offs growing to 0.64 percent in the fourth quarter of 2010, up from 0.26 percent one year earlier. Nonperforming loans grew from 2.22 percent of total loans to 2.40 percent during 2010, ending the year 72 basis points above the national community bank median and almost 50 percent higher than the same ratio at year-end 1991.

Additions to reserves for future loan losses represented a falling share of the industry's net revenue in 2010, potentially suggesting that the rate of credit quality deterioration is slowing. Coverage ratios for Fifth District banks leveled off in 2010, with a median of 63 cents in reserves for every dollar in nonperforming loans. By comparison, the most recent trough was in the third quarter of 1991 at 88 cents. Bank capital positions, the other source of loan loss absorption, improved slightly in 2010 at the national level and among the District's larger institutions, while continuing to decline for District community banks. On the positive side, District banks' median net interest margins (that is, net interest income relative to average earning assets) improved in 2010, closing in on the national statistic after a seven-quarter gap. Moreover, the share of unprofitable banks in the District declined year-over-year from 41 percent to 31 percent at year-end 2010.

Looking Ahead

Although the Fifth District economic recovery strengthened during the year, the rebound was tepid and conditions remained relatively weak throughout the District. The growth in U.S. GDP and national consumer spending toward the end of 2010, however, combined with some promising regional business and labor market indicators at the beginning of 2011, provides hope for a stronger recovery in 2011. Real estate activity—particularly residential real estate activity—is likely to remain subdued during the year, but increased optimism among District businesses and consumers should provide the momentum for growth that the region has been seeking. ■

Note: Regional economic data are current as of March 10, 2011. Banking conditions data are current as of February 25, 2011.