

Fifth District Economy Continued to Stabilize in 2011

The Fifth District economy—like the national economy—remained weaker in 2011 than most economists and policymakers had anticipated at the outset. Slow growth in gross domestic product and consumer spending in the United States was reflected in Fifth District economic activity as the region faced weak retail spending, sluggish labor markets, and continued uncertainty among area businesses. Exacerbating the economic uncertainty was the wrangling over the debt ceiling and potential budget cuts, which would have a sizeable impact on the District, where the federal government's presence is particularly strong.

Meanwhile, area banks continued to operate in a challenging environment, and real estate activity remained subdued as expected. Despite the prolonged weakness, however, a gradual recovery in the District seemed to take hold across several sectors of the economy in the second half of 2011.

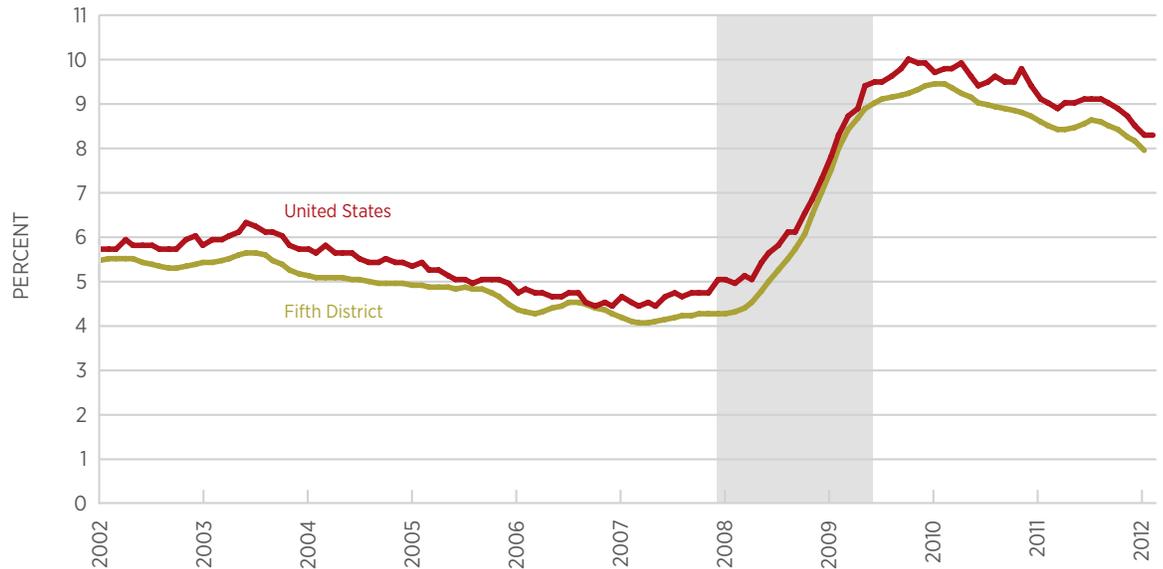
Labor Market Conditions

Although labor markets in the Fifth District did not rebound as strongly as might be expected after such a deep recession, District hiring activity did pick up in 2011 after two years of employment decline (2008 and 2009) and a third year of slow growth in 2010. (See Figure 1.) The District's net job increase of 168,600 workers in 2011 exceeded the increase in 2007. Employment growth was uneven during the year, however. Much of the momentum in the first quarter of 2011 was lost to payroll declines or inconsistent growth in the late spring and summer months before hiring activity picked up again in the fall. National employment growth also slowed in the middle of the year, but U.S. employment slightly outperformed District employment over the year, growing 1.4 percent compared to the District's 1.3 percent.

The District's overall employment trend in 2011 was driven primarily by increases in the professional and business services sector and the education and health services sector, although the leisure and hospitality sector and the trade, transportation, and utilities sector also expanded notably. Annual gains were distributed somewhat evenly across District states, with most states posting job growth of between 1 percent and 2 percent in 2011. The sharpest deviation was the District of Columbia, where employment expanded 2.8 percent.

Private sector hiring drove overall job expansion in the Fifth District; government employment in the District grew only 0.3 percent (6,800 net jobs) in 2011. Those gains were concentrated entirely in federal government employment, which expanded 1.4 percent (8,800 jobs). Only the District of Columbia and West Virginia reported contractions in federal government employment. Meanwhile, state and local governments in the Fifth District reduced their payrolls by 2,000 workers. North Carolina and South Carolina combined trimmed 14,600 state and local government jobs, while Virginia added more than 9,000 state and local government jobs.

FIGURE 1
Unemployment Rates in the Fifth District and the United States



Sources: Bureau of Labor Statistics, Haver Analytics

Federal Government Presence

Challenges facing state and local governments during the past few years reflected national trends. The federal government, on the other hand, plays a unique role in the Fifth District. In March 2011, approximately one-quarter of all federal government workers were employed in the District—clustered in and around Washington, D.C., and in numerous civilian and military facilities across the Fifth District. In fact, the federal government is the Fifth District’s largest employer. Even excluding the U.S. Postal Service and the military, the federal government employed 4 percent of District workers in March 2011; in the United States as a whole, the federal government employed only 1.6 percent of workers.

Of course, non-defense employment statistics understate the role of the federal government in the District because of the large military presence. From the Pentagon in Washington, D.C., to the Navy installations in Hampton Roads, Va., to Fort Bragg in

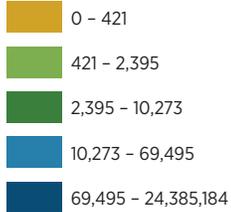
Fayetteville, N.C., the military is an important engine of local employment. According to 2009 data, more than 250,000 military personnel—23.5 percent of the nation’s total—are stationed in the District.

Even including military personnel, the role of the federal government in District labor markets is understated. In addition to grants, loans, guarantees, direct payments, insurance, and other expenditures, the federal government purchases goods and services through contracts with private sector businesses—a sizeable number of them in the Washington, D.C., metropolitan area. Federal contract spending grew 10.3 percent per year on average from 2000 through 2010, representing approximately 0.8 percent of the District’s economy during that time. (See Figure 2.)

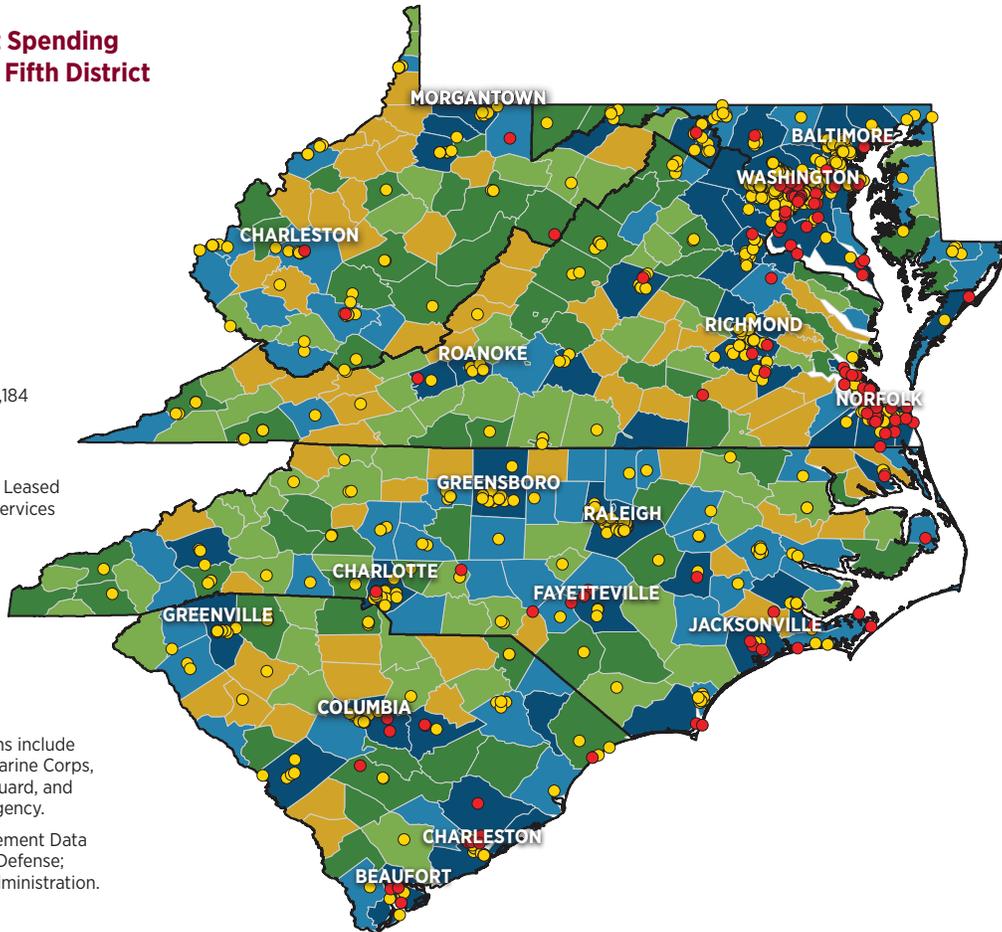
Federal jobs and spending sheltered the District from some of the labor market contractions that affected

FIGURE 2
Federal Contract Spending
By County in the Fifth District
 (Fiscal Year 2010)

\$ In Thousands



- Military Installations
- Properties Owned or Leased by the U.S. General Services Administration



Note: Military Installations include installations for Army, Marine Corps, Navy, Air Force, Coast Guard, and the Defense Logistics Agency.

Sources: Federal Procurement Data System; Department of Defense; U.S. General Services Administration.

the rest of the country in the latest recession. The District's unemployment rate has remained consistently below the national average, largely due to low unemployment in the Washington, D.C., metropolitan area (which includes parts of Maryland, Virginia, and West Virginia). However, if federal budget problems lead to a significant reduction in federal spending in 2012, this would affect District labor markets markedly more than labor markets in other parts of the country. Already, there are reports that the uncertainty surrounding the federal budget impeded business spending and investment in 2011. Also, military and civilian employees are likely to be affected by federal budget cuts in 2012. Even if those spending cuts do

not lead to outright elimination of jobs, they could produce further pay freezes or reductions that would affect residents of the District disproportionately.

Real Estate Conditions

As in the nation, real estate markets in the Fifth District remained weak throughout 2011. Housing markets stabilized and improved modestly—both in number and value of sales—toward the middle of the year, but activity remained sluggish at best. In general, sales of low- to mid-price homes continued to fare better than sales of more expensive homes, and short sales—which occur when a home is sold for less than

the outstanding mortgage balance and the mortgage lender agrees to a lower payout—represented a sizeable share of total activity in most markets.

Continued delinquency and foreclosure activity only exacerbated the excess inventory problem in the District. Although the share of mortgages with payments more than 90 days past due stabilized in 2011, the foreclosure inventory continued to rise. By the end of the year, the District had more than 145,000 mortgages in foreclosure, representing 3.1 percent of all mortgages in the region. Of the Fifth District jurisdictions, only Virginia and West Virginia did not suffer a rise in the number of homes facing foreclosure in 2011. In more positive news, the share of mortgages with payments more than 90 days past due decreased in all Fifth District states. Only D.C. saw an increase in that category.

With slow home sales and high inventories, it is not surprising that house prices continued to fall, albeit at a much slower pace. According to data from the Federal Housing Finance Agency, house prices in the District fell notably in the first two quarters of the year, and although prices stabilized toward the end of the year, home values still depreciated 2.4 percent over the course of 2011. This trend was evident across all Fifth District states. Only the District of Columbia reported higher home values for the whole year.

Most sources indicated that commercial real estate activity was stable over the course of 2011, but reports were inconsistent throughout the year. Generally, vacancy rates neither rose nor fell notably in most District markets, and the reports of improved sales of office, industrial, or retail space were roughly matched by those stating that demand was stagnant across all commercial markets. In general, the ratio of leasing to buying increased over the year, and challenges in obtaining financing continued to hold up many deals.

Banking Conditions

Over the course of 2011, banks faced numerous challenges, including regulatory changes, a U.S. sovereign

debt downgrade, distressed international markets, continued slow economic recovery, and a subdued housing market. Despite these challenges, banks in the Fifth District and nationwide hinted at slight signs of recovery through stabilizing credit quality and modest improvement in earnings.

The share of unprofitable institutions in the District decreased from 31 percent to 25 percent during the year. Moreover, the median return on average assets for banks in the District improved 10 basis points to 0.45 percent, but remained well below the national median of 0.77 percent. Large institutions (banks with total assets greater than \$1 billion) faced heightened earnings pressures due to the current low-rate environment. Margins at these institutions constricted as pressures on loan yields more than offset lower interest expense. For smaller banks, lingering credit quality issues continued to hamper earnings. Loan losses remained most noticeable in commercial and residential real estate portfolios. Because small District banks (those with total assets less than \$1 billion) held higher concentrations of these loans before the recession, their credit quality improvement continued to lag the nation. At 1.27 percent, aggregate losses as a percentage of loans at small institutions remained higher than at their nationwide peers (0.89 percent). For the first time since the recession began, however, losses trended downward, ending the fourth quarter 19 basis points below year-end 2010. Banks were able to reduce their reserves for future loan losses, aiding a slight upward trend in earnings.

Capital positions also improved, primarily driven by deleveraging and continued marginal balance sheet contraction due to negative annual loan growth. Though District levels have trailed the national median since the previous recession, capital ratios began a long road to recovery in 2010 and improved steadily over the course of 2011. The increasing rate of capitalization was driven by large institutions, while smaller banks that had built relatively substantial reserve balances before the recession saw levels stabilize in 2011 after drastic reductions in capital over the past four years.

Business Conditions

The first part of 2011 saw challenging but improving conditions for businesses in the Fifth District. Manufacturing activity remained quite strong, although high energy and commodity prices squeezed margins for many District manufacturers in the first part of the year—a phenomenon that was exacerbated by turmoil in the Middle East. Many businesses also expressed an unwillingness to invest significantly given uncertainty about the direction of government policy and the federal budget. Nonetheless, businesses—particularly manufacturing firms—remained upbeat about rises in domestic and international demand for goods in early 2011.

As the year progressed, some manufacturers reported strong demand and potential expansion, but many others cited uncertain global conditions and sluggish consumer spending domestically as drags on their business. The Federal Reserve Bank of Richmond maintains a composite manufacturing index based on the Bank's Fifth District Survey of Manufacturing Activity. The index started the year firmly in positive territory, but spent most of the summer and autumn months below zero. (The Bank's manufacturing and service sector indexes are diffusion indexes. A positive reading indicates that the number of firms reporting expansion exceeded the number of firms reporting contraction.) The March tsunami in Japan negatively affected some District manufacturers, mostly auto parts suppliers. Export activity remained generally steady throughout the year, although imports were soft, perhaps due to sluggish demand in domestic retail. On the whole, 2011 brought tighter margins for District manufacturers, but a more positive outlook than any of the three previous years.

The service sector also contracted somewhat toward the middle of 2011. The Bank's service sector indexes for revenues and employment were below zero for most of the summer and early autumn months. Retail activity was weak, as well, as increased consumer uncertainty manifested itself in a particularly volatile index for retail revenues throughout 2011.

Summary

Neither the national nor the Fifth District economy did as well in 2011 as was hoped or anticipated. Generally weak economic conditions were compounded by uncertainty engendered by national policy debates and concerns about global markets. As consumer spending and retail activity remained weak, businesses held back and labor markets continued to struggle. Furthermore, as expected, residential and commercial real estate activity was weak, and banks struggled in a challenging lending environment. Despite all of this, the economy continued to stabilize throughout 2011 and began to recover and improve toward the end of the year. ■

Note: Regional economic data are current as of March 13, 2012. Banking conditions data are current as of December 31, 2011.