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Regional Economic Update



The views expressed are those of the author and do not necessarily reflect the opinions of the Federal Reserve Bank of Kansas City or the Federal Reserve System.

Today's Roadmap

- **Who is the Fed?**
- **Financial crisis update**
- **Economic update**
- **Agriculture and rural update**



Missions of the Federal Reserve

- **Founded in 1913 with 3 core missions:**
 - Promote an efficient payments system
 - Safeguard the competitiveness, safety and soundness of the banking system
 - Conduct monetary policy



An Independent Fed

- **The Fed is self-supporting to maintain political independence.**
- **Income sources:**
 - Interest on loans to financial institutions
 - Income from services
 - Interest income from US Treasury bonds, bills and notes
- **Balance of Power: The Political Fight for an Independent Central Bank, 1790 – Present**
 - <http://www.kc.frb.org/>



Structure of the Fed

- **Board of Governors**
- **12 Regional Reserve Banks**
- **Federal Open Market Committee**



Board of Governors

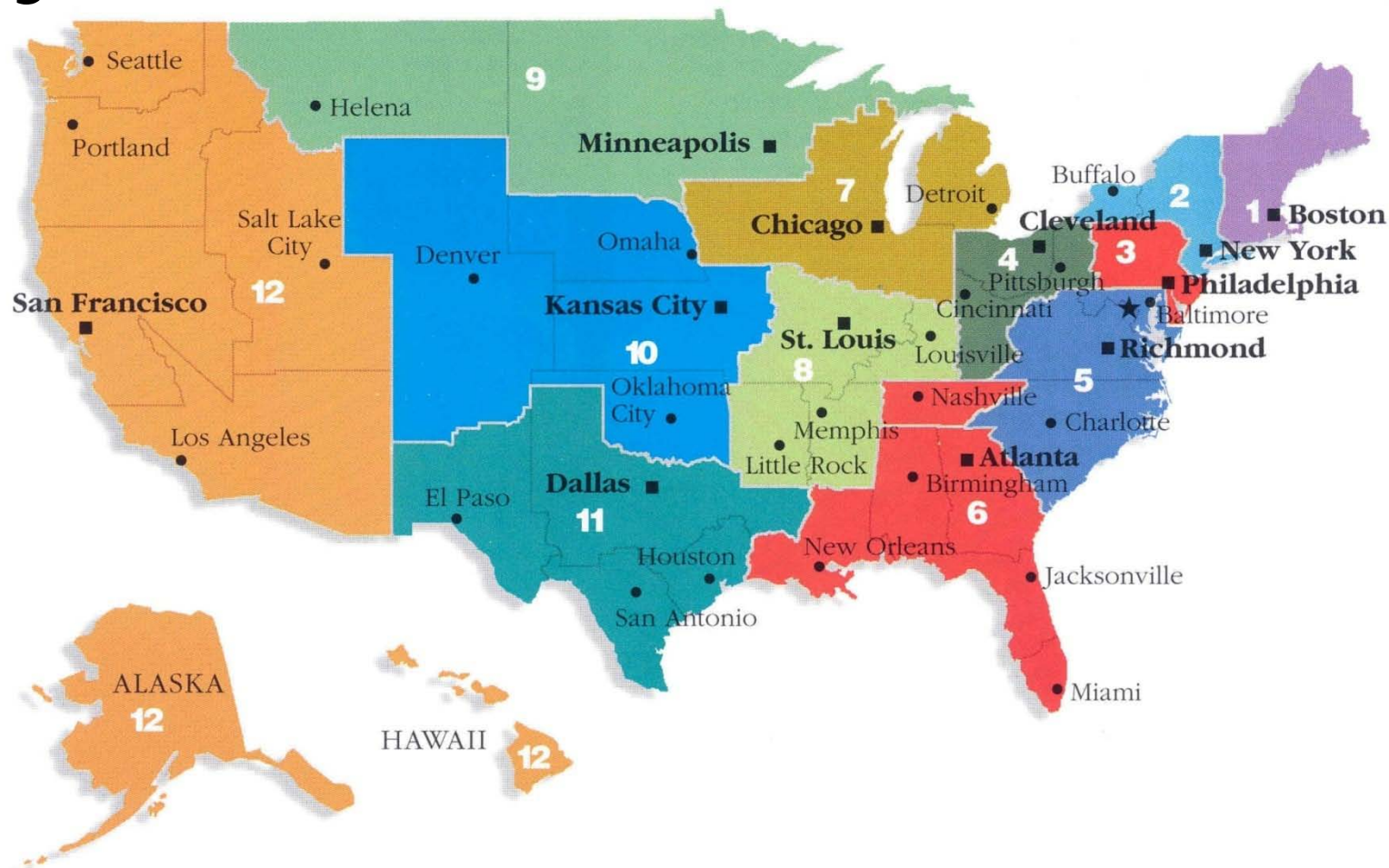
- **7 members**
 - Appointed by President, confirmed by Senate
 - 14-year terms
 - Current chairman –
Ben Bernanke
- **Supervise Reserve Banks**



Regional Reserve Banks

- 25 branch offices

- Fed member banks



Federal Open Market Committee

- Monetary policy making body
- 7 Governors, NY Fed President, 4 other Fed Presidents
- Remaining Reserve Bank presidents participate in discussions



Two Kinds of Economic Policy

■ Monetary Policy

- Changes in the level of money and credit in the economy
- Implemented by the Federal Reserve

■ Fiscal Policy

- Changes in government spending and tax programs
- Implemented by the Executive and Legislative branches



Monetary Policy Objectives

- Two primary objectives
- Price stability
- Sustainable economic growth

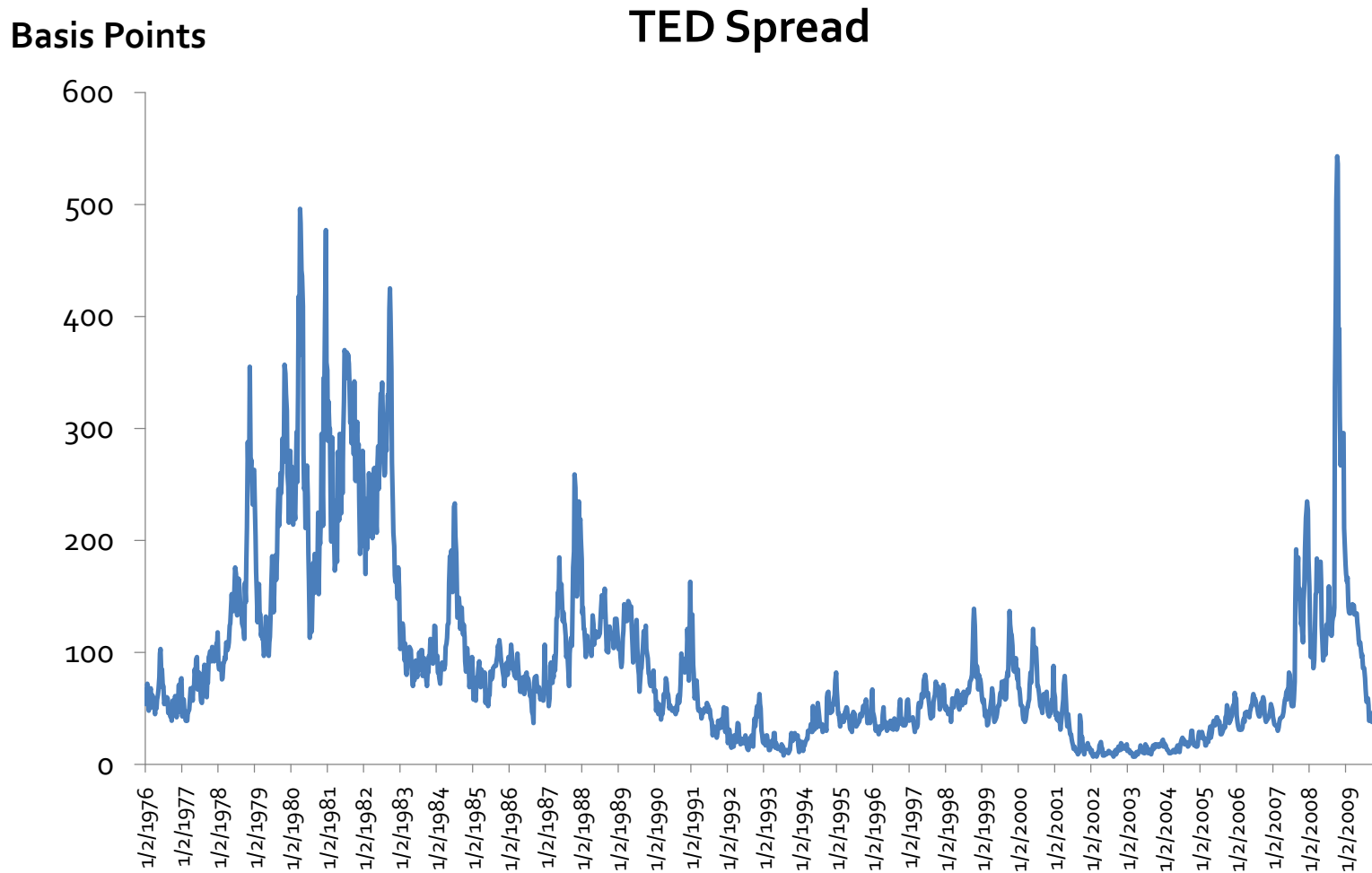


Today's Roadmap

- What is the Fed?
- Financial crisis update



The financial market crisis has eased.



Source: Federal Reserve Board of Governors



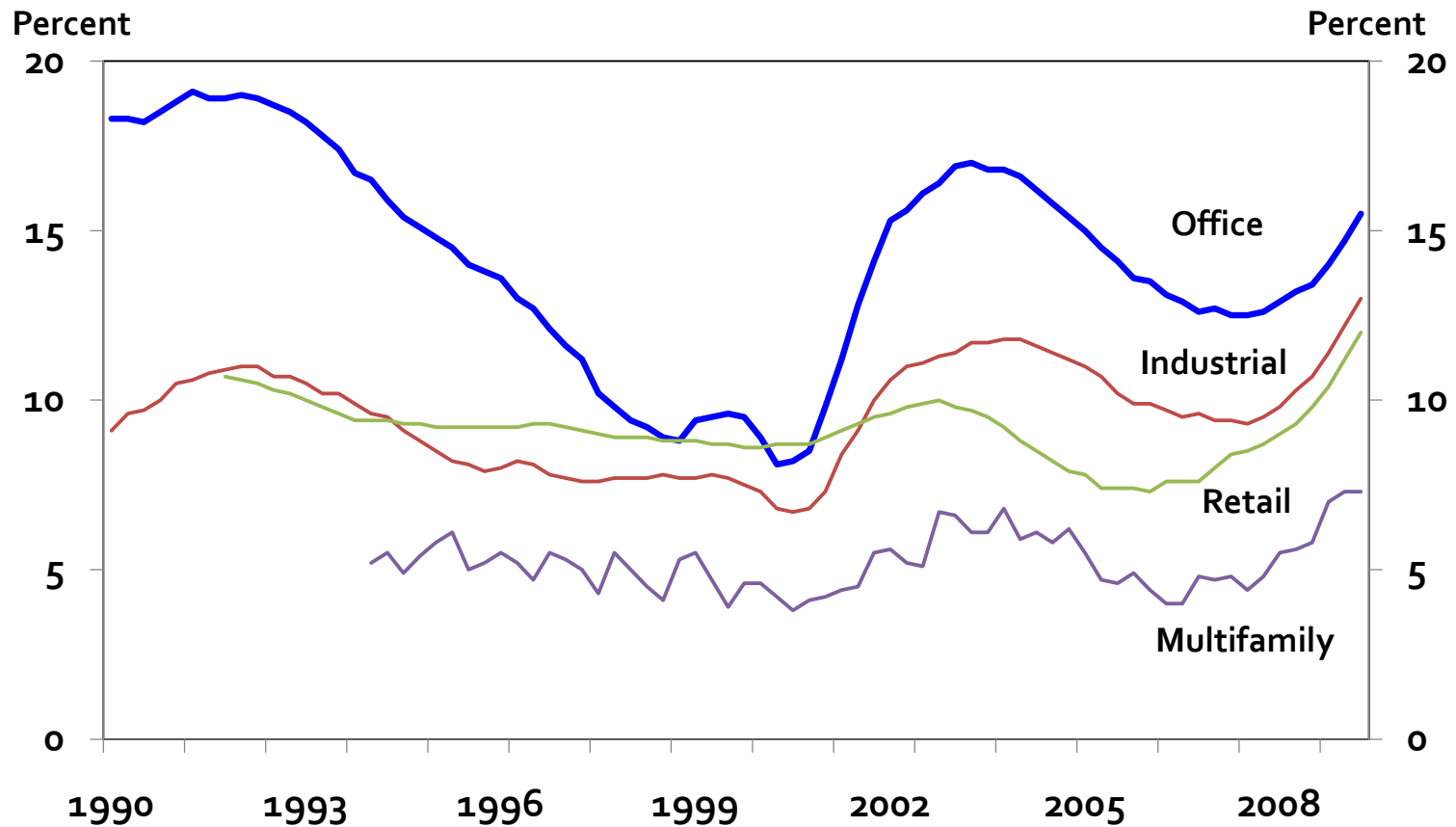
While the financial crisis has eased, risks still exist in the economy.

- Probably the one risk most talked about today is commercial real estate (CRE)
- Most banks are exposed to CRE and/or have exposures to commercial mortgage backed securities (CMBS)
- Eventually, CRE will need to be refinanced...who will do this in today's market?



U.S. commercial vacancy rates are rising.

U.S. Commercial Real Estate Vacancy Rates

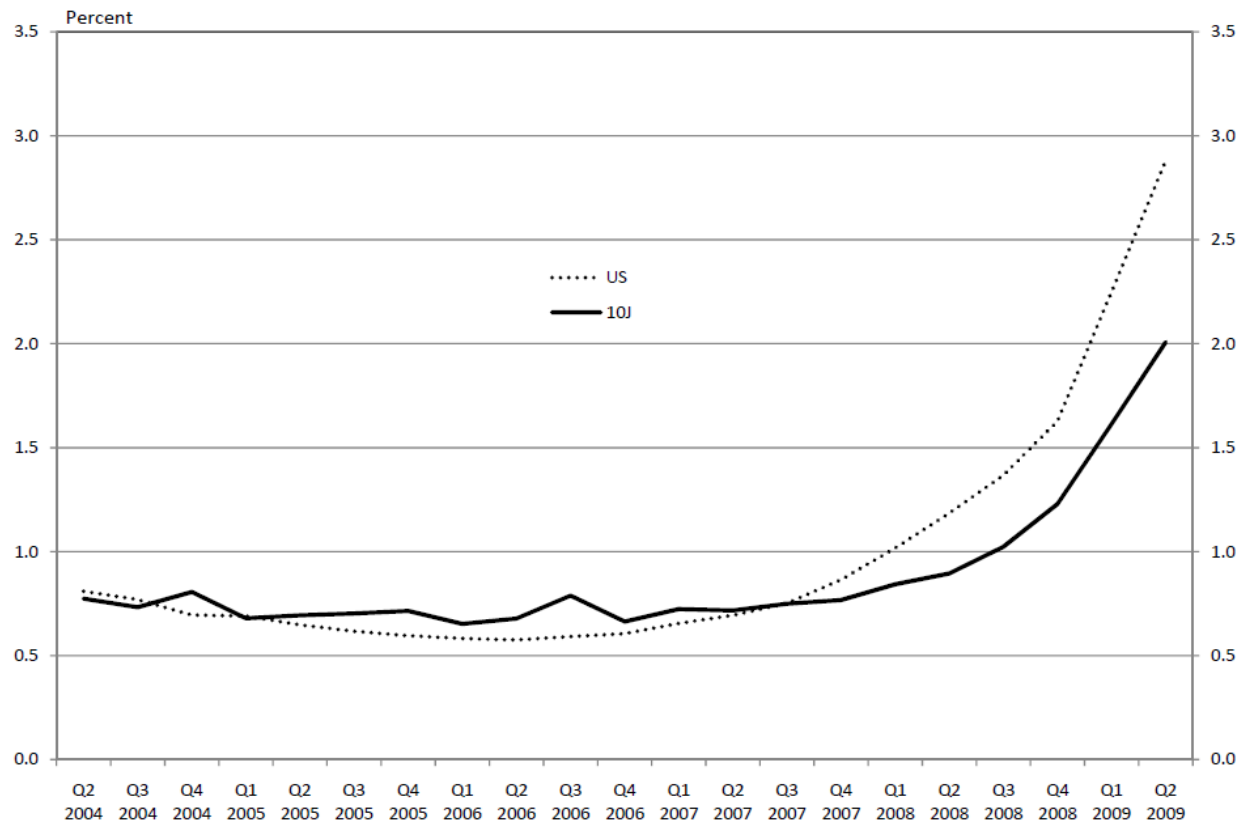


Source: Torto-Wheaton Research



The share of CRE loans past due are rising.

Share of CRE loans past due

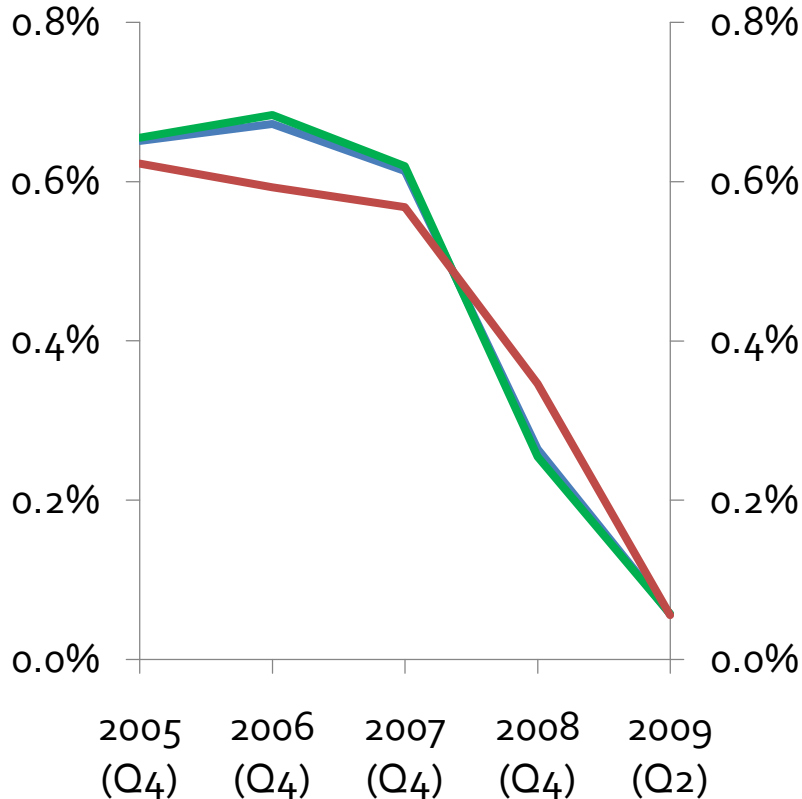


Source: FDIC



While commercial banks' profitability has fallen, capital levels have risen.

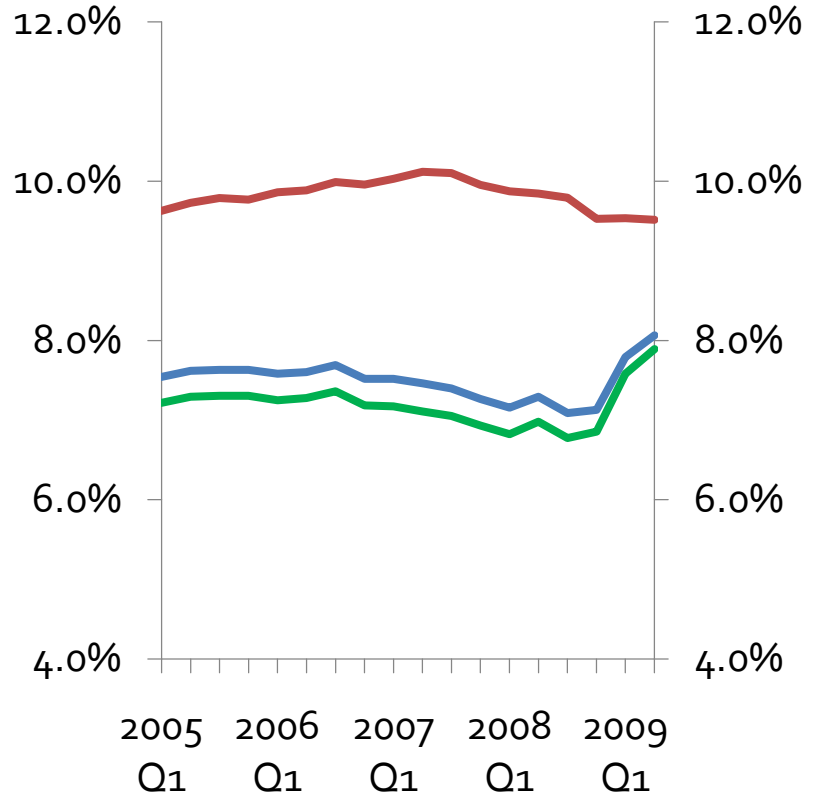
Return on Assets



— All Commercial Banks
 — Banks > \$1B Assets
— Banks < \$1B Assets

Source: FDIC

Tier 1 Capital Ratio



— All Commercial Banks
 — Banks > \$1B Assets
— Banks < \$1B Assets

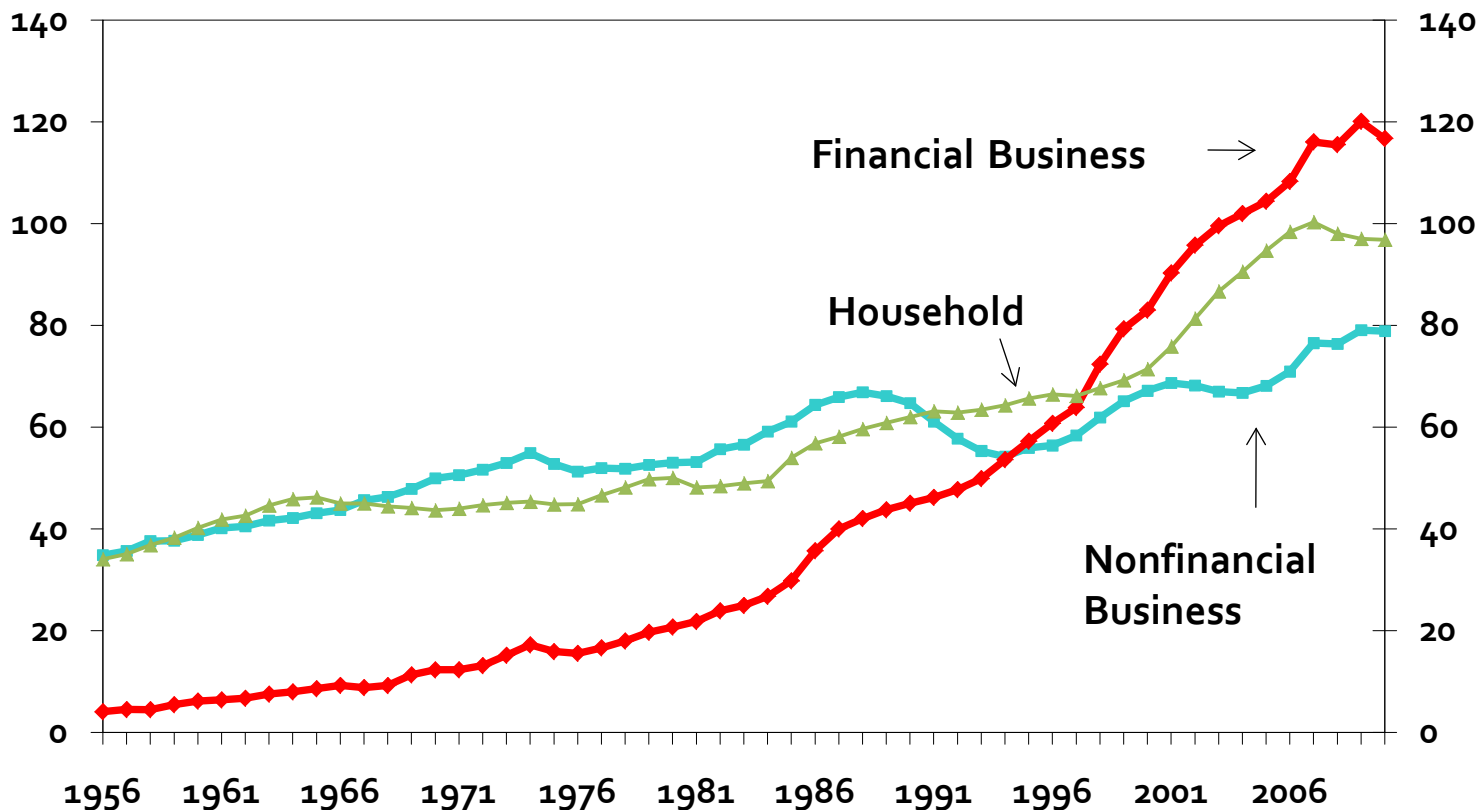
Source: FDIC



The U.S. is going through a de-leveraging process.

Domestic Debt Outstanding

Percent of GDP



Source: Federal Reserve Board of Governors



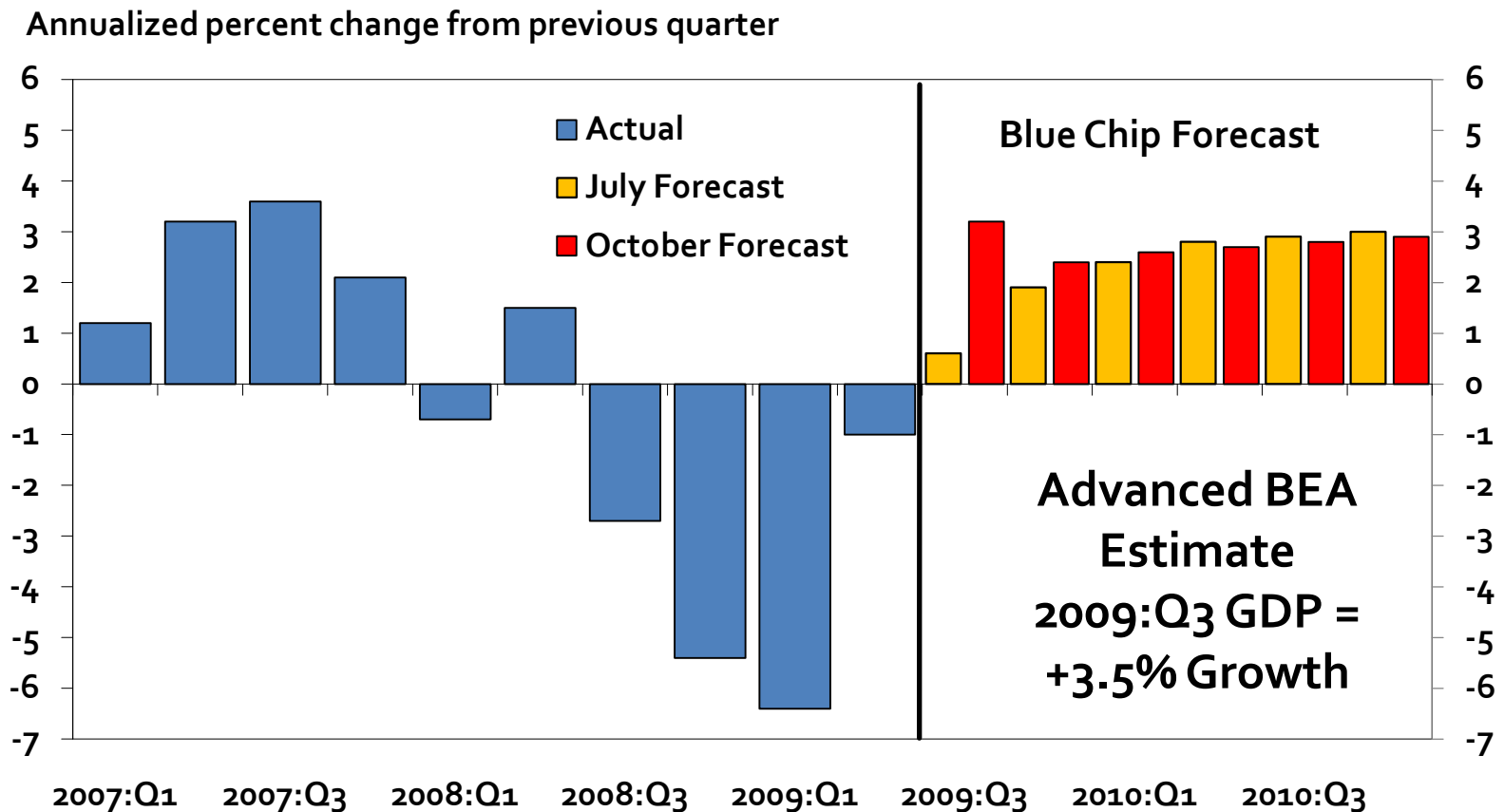
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Forecasters expect we have hit bottom and should return to growth.

Real GDP Growth

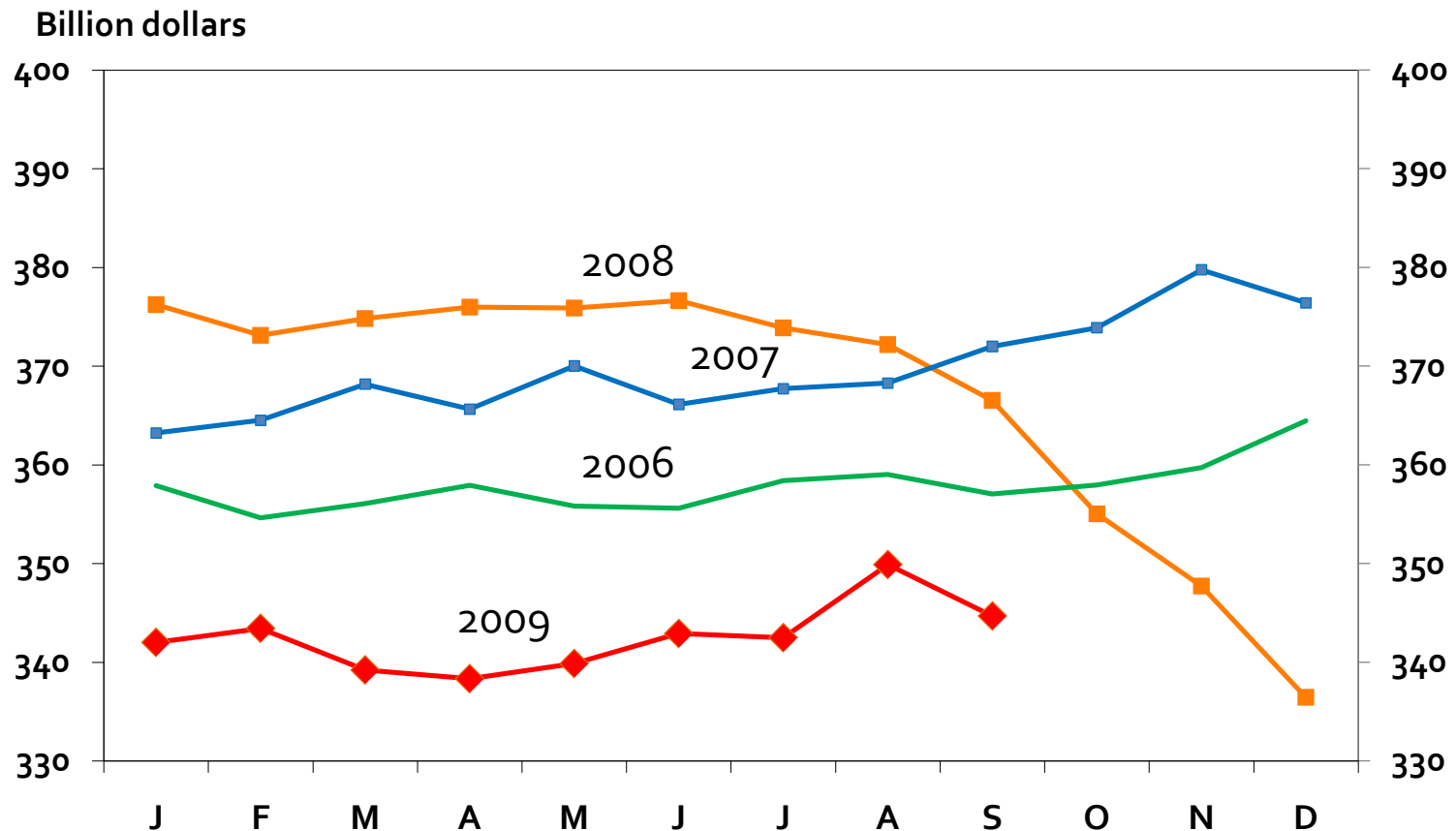


Source: Bureau of Economic Analysis and Blue Chip Economic Indicators



Since 2008, retail sales have fallen. Recent boost from cash-for-clunkers, but is it sustainable?

U.S. Monthly Retail and Food Sales



Source: U.S. Census Bureau



The unemployment rate continues to rise.

U.S. Unemployment Rate

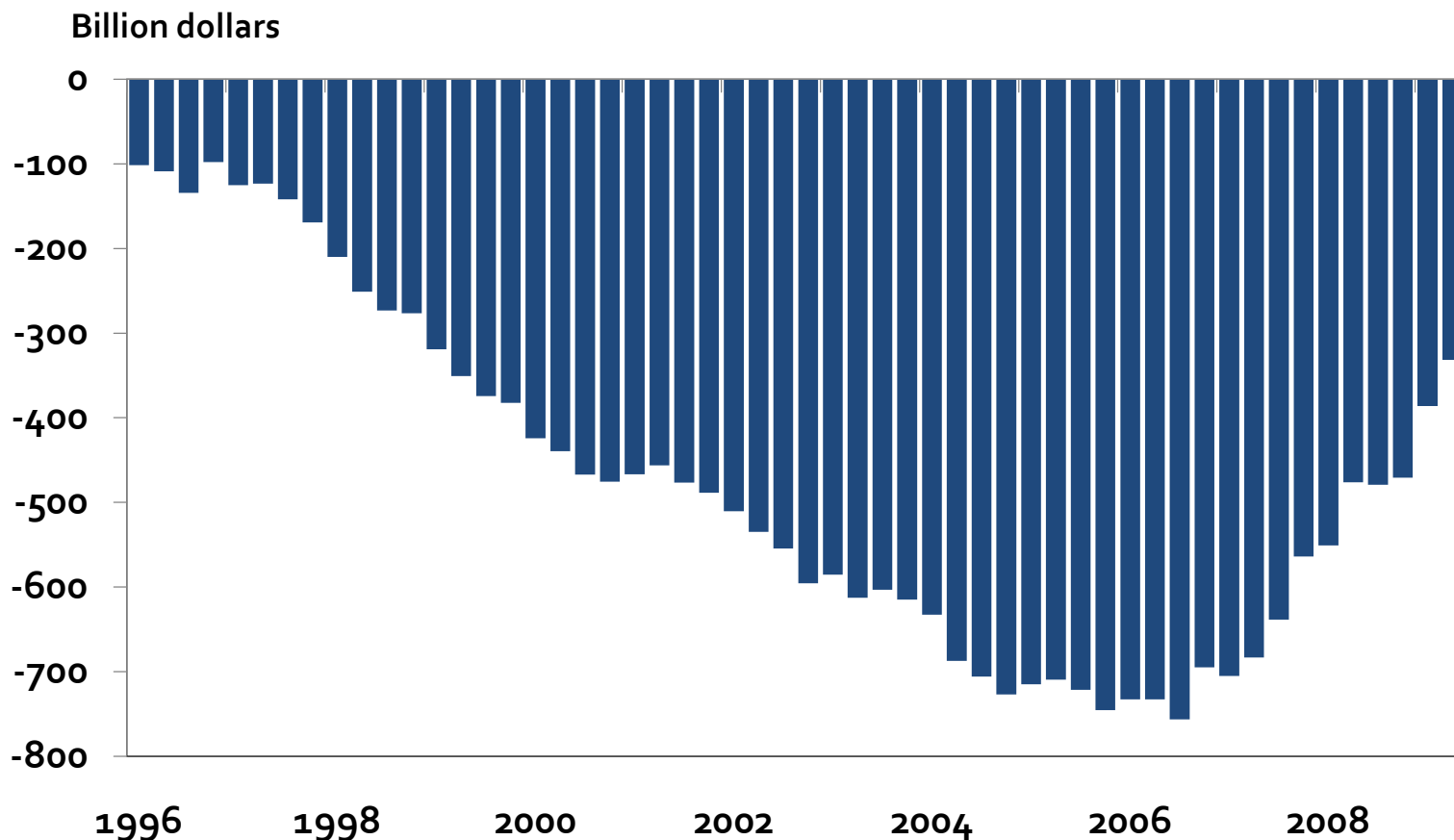


Source: Bureau of Economic Analysis



Improvements in the U.S. trade balance continue.

Real Net Exports of Goods and Services



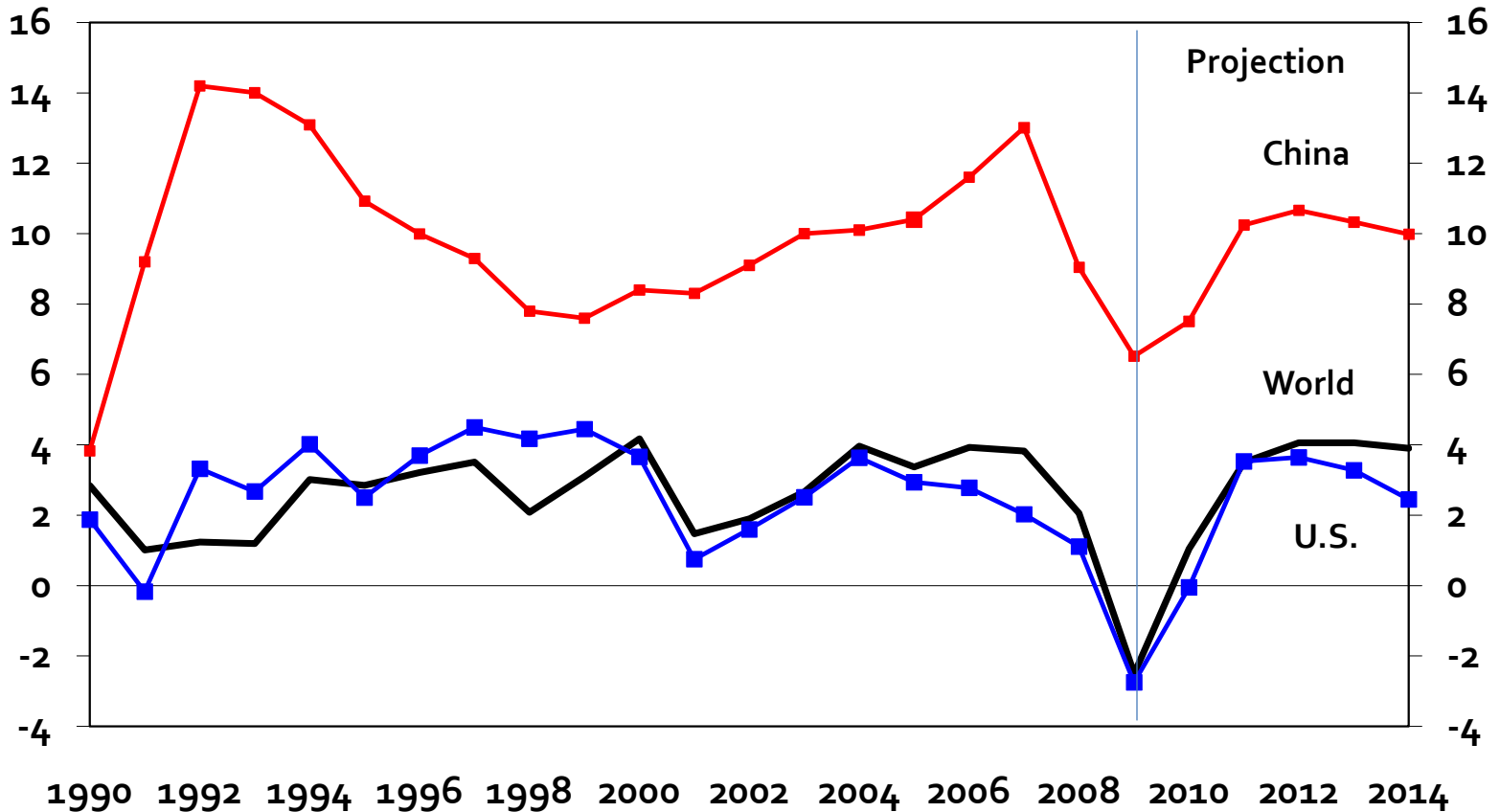
Source: Bureau of Economic Analysis



Will emerging countries lead the recovery?

GDP Growth

Annual percent change, constant dollars



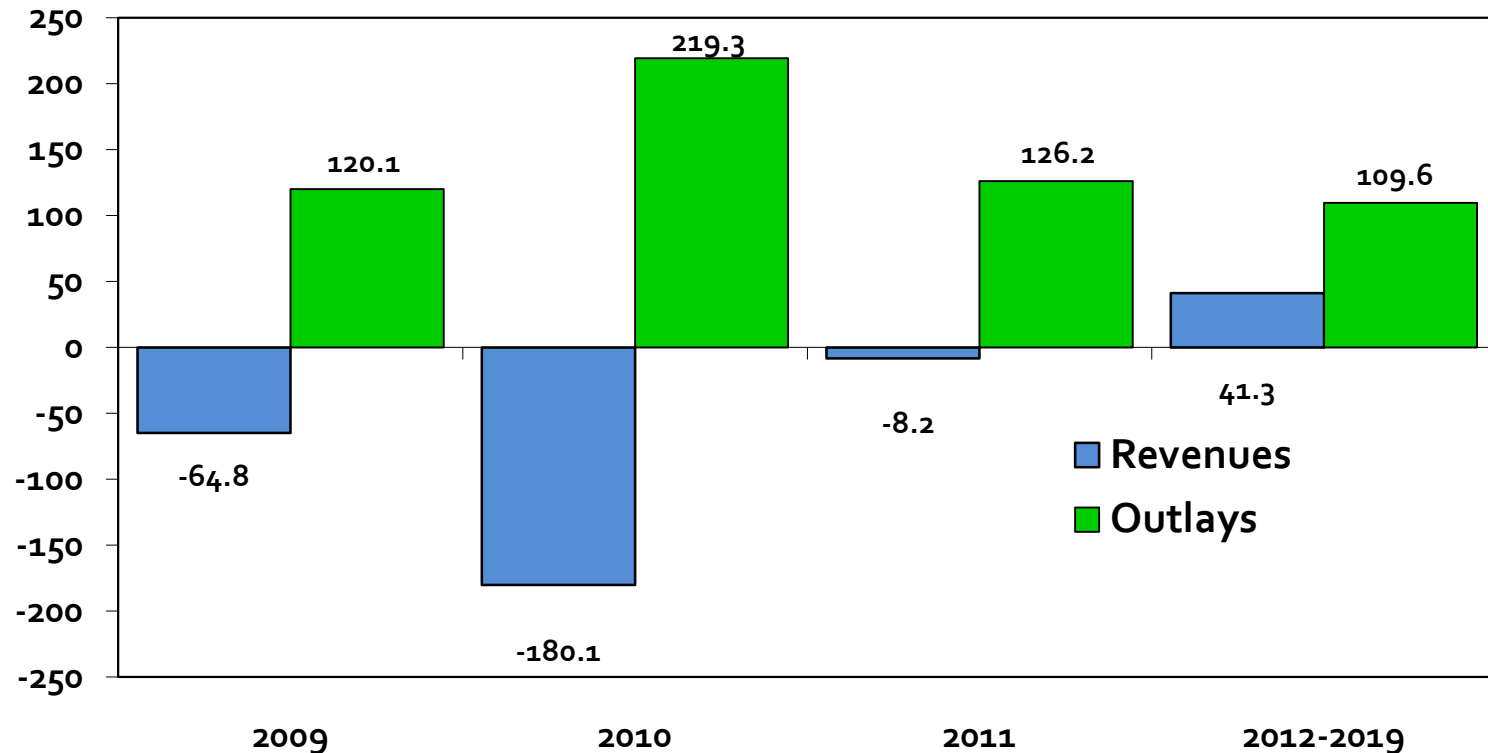
Source: International Monetary Fund, April 2009



The bulk of the stimulus package comes in 2010.

Estimated Budget Impact of American Recovery and Reinvestment Act (ARRA) of 2009

Billion Dollars



Source: Congressional Budget Office, February 13, 2009



Deflation, Disinflation, Inflation: What is the difference?

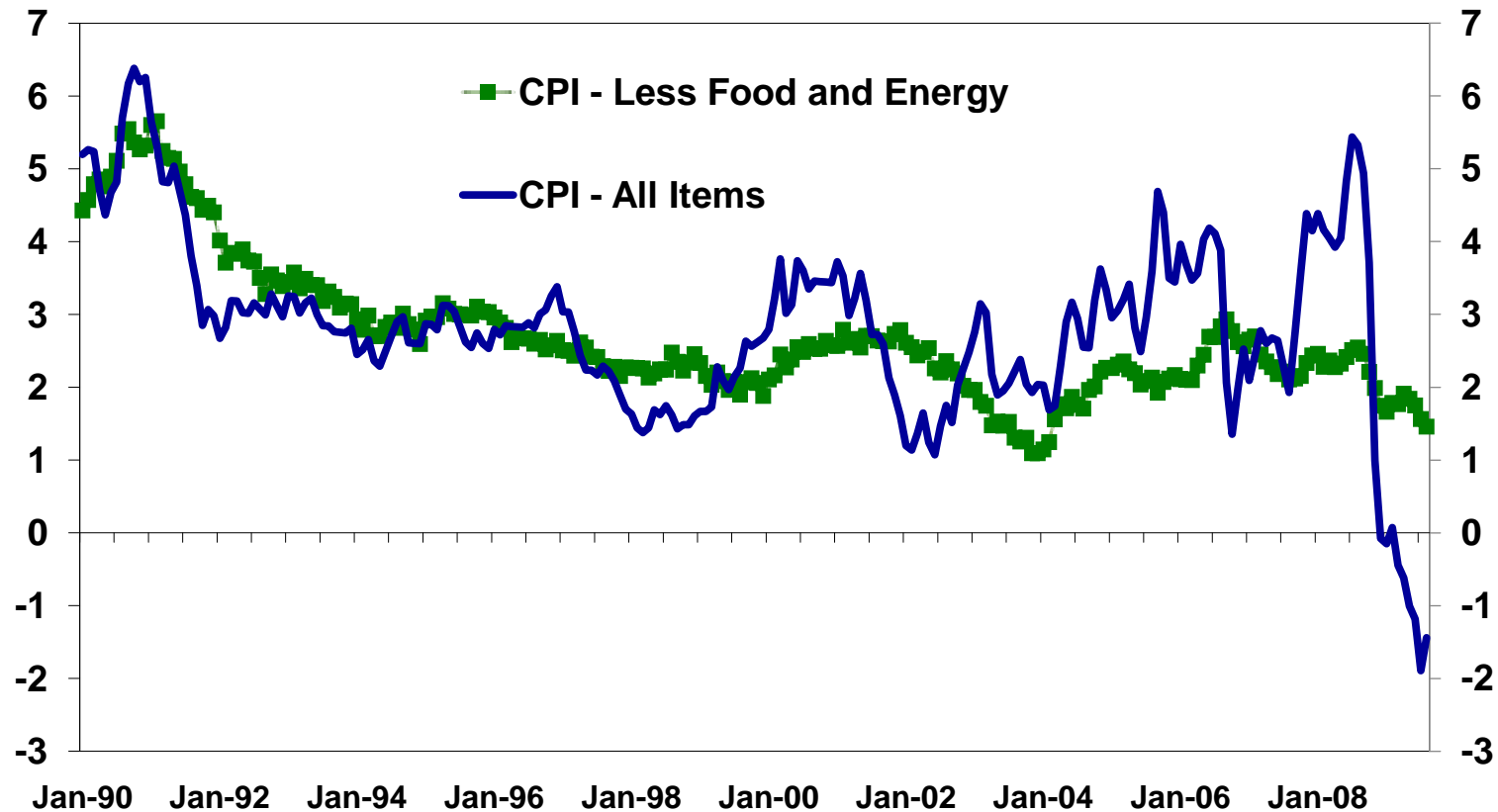
- Deflation: a **fall** in the general level of prices of goods and services in an economy over a period of time.
For example, $CPI < 0$
- Inflation: a **rise** in the general level of prices of goods and services in an economy over a period of time.
For example, $CPI > 0$
- Disinflation: **a decrease in the rate of inflation** – a slowdown in the increase of the general price level of goods and services over time.
For example, $CPI > 0$, but falling from 2.5 to 1.5%



The U.S. is experiencing disinflation.

Consumer Price Inflation

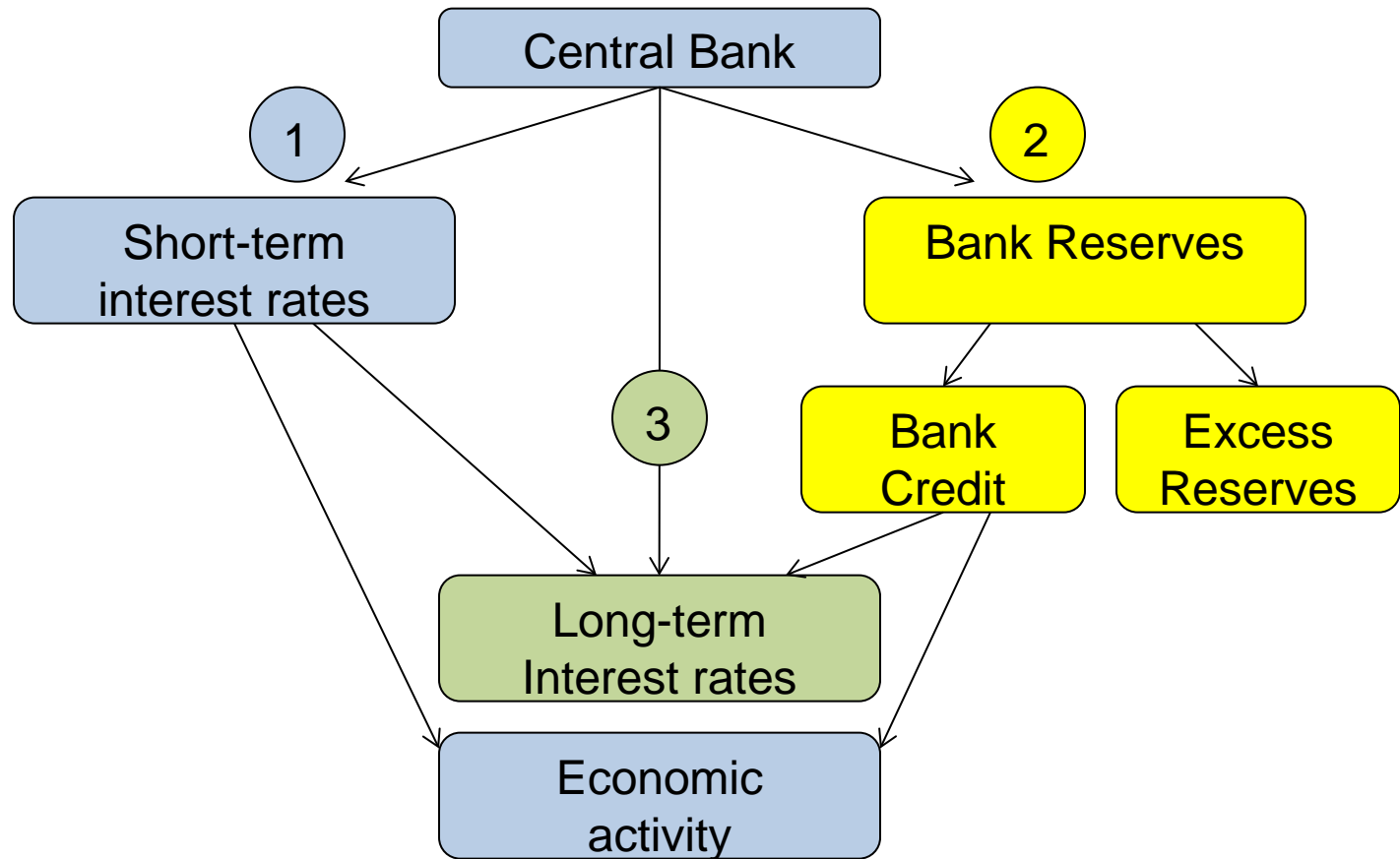
Percent



Source: Bureau of Labor Statistics



Monetary Policy Transmission Mechanisms



Source: Gordon Sellon (2003) "Monetary Policy and the Zero Bound: Policy Options When Short-Term Rates Reach Zero"
Economic Review <http://www.kansascityfed.org/Publicat/ECONREV/PDF/4q03sell.pdf>



The Fed has expanded its balance sheet to extend credit to banks.

- Prior to September 2008, the Fed was sterilizing liquidity injections to capital markets.

- Expansion of short-term lending through Term Auction Facility (TAF) - **Green**

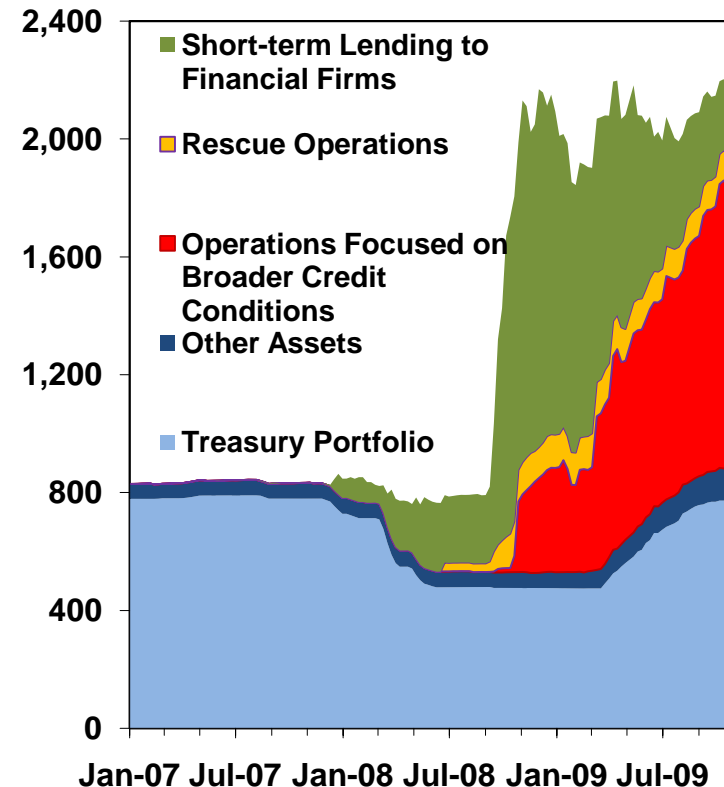
- Offset by lower treasury portfolio - **Blue**

- After September 2008, Fed unable to sterilize liquidity injections through the discount window and various lending facilities.

- The creation of the Term Asset-backed Securities Loan Facility (TALF) to acquire consumer loans could expand the balance sheet even further.

Federal Reserve Balance Sheet

Billions of Dollars

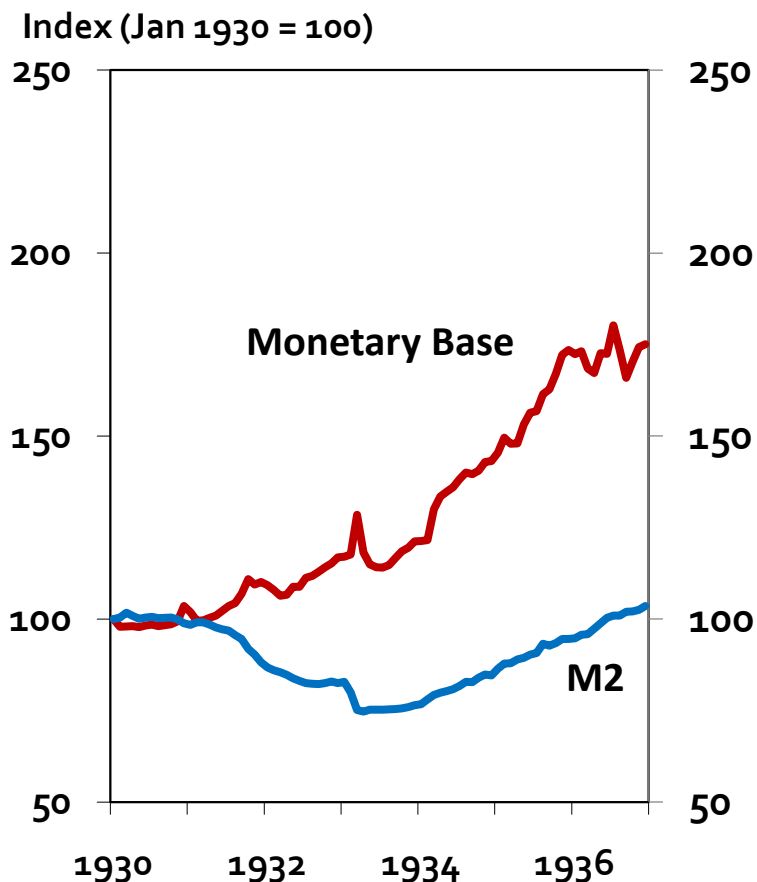


Source: Federal Reserve Board of Governors

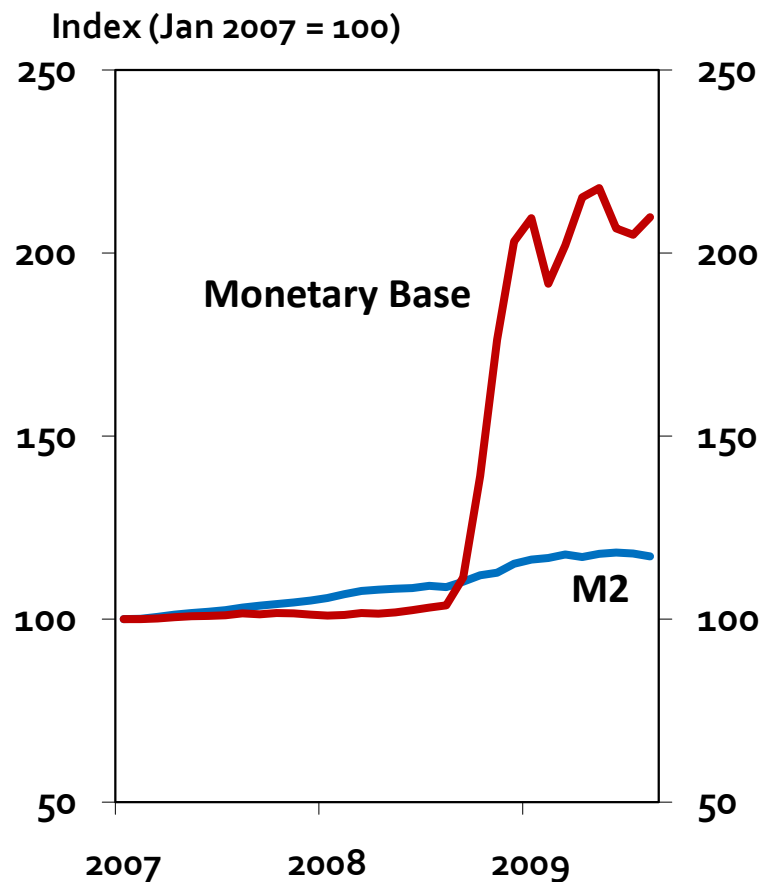


Unlike the Great Depression, money stock (M2) has edged up with a surge in the monetary base.

Growth in Monetary Aggregates



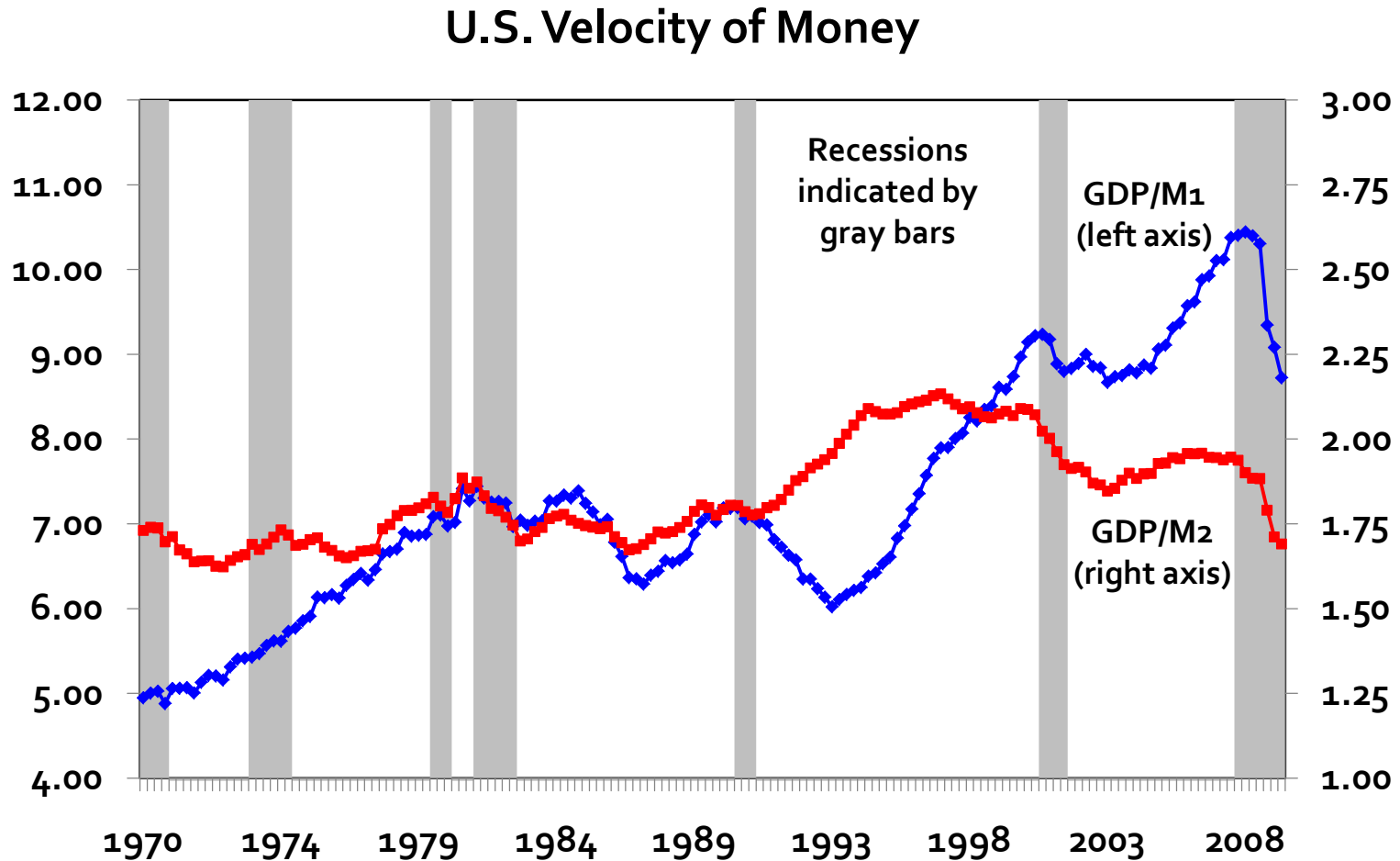
Source: Federal Reserve Bank of St. Louis,
Friedman and Schwartz



Source: Federal Reserve Board of Governors



The velocity of money has plummeted.



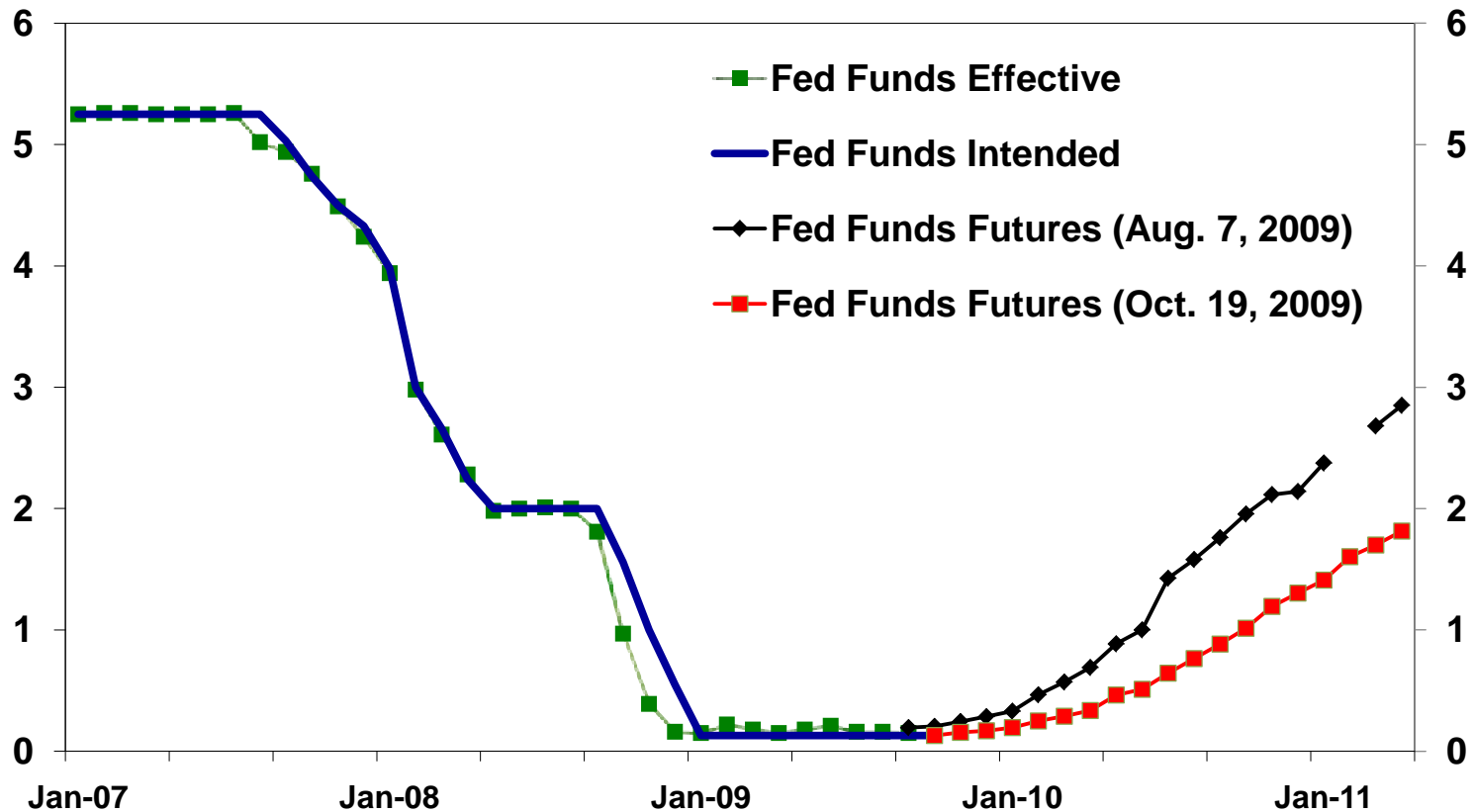
Source: BEA and Federal Reserve Board of Governors



What is the future path of interest rates?

Fed Funds Rate

Percent



Source: Federal Reserve Board of Governors and CME Group



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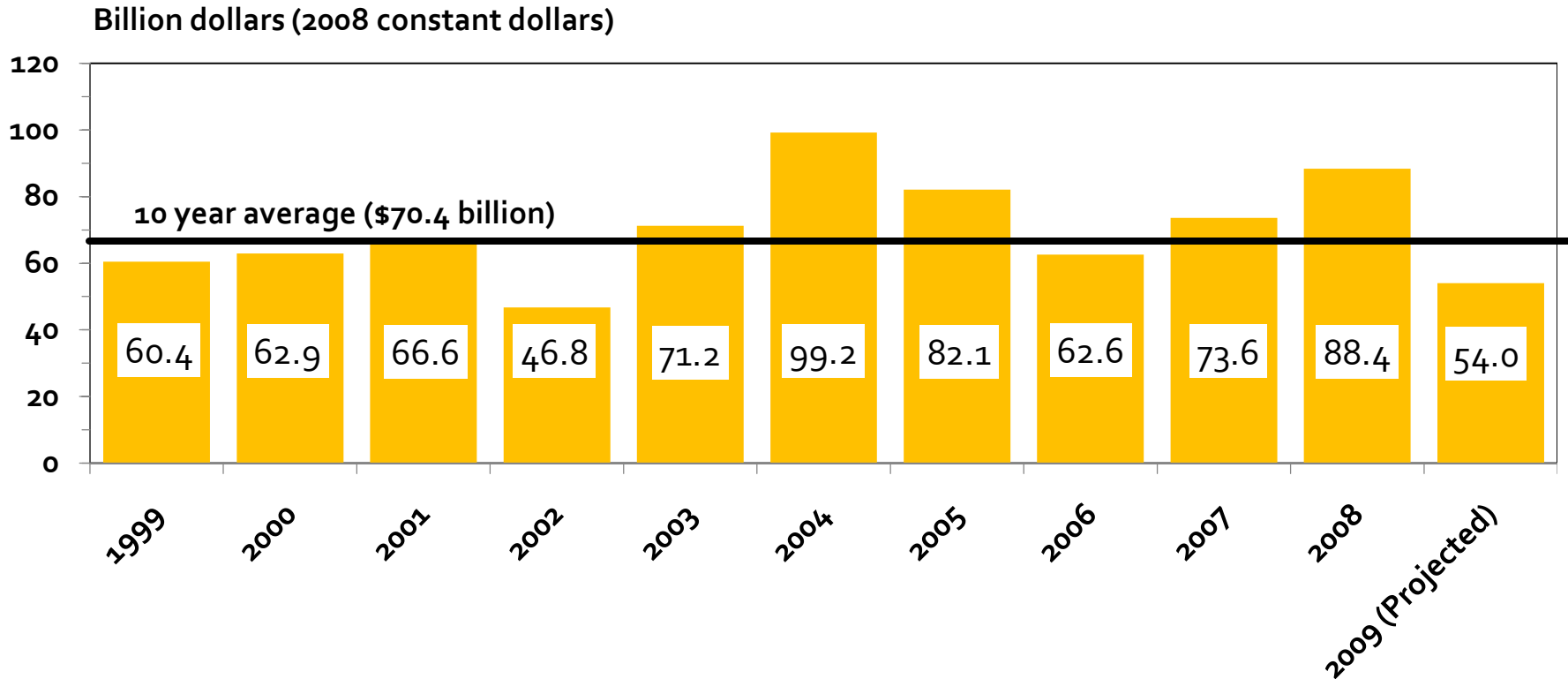
What does all of this mean for U.S. agriculture?

- **USDA projects net farm incomes will fall by 38 percent this year**
 - **But remember, this fall is from a very high level (2008 net farm income levels)**
- **Depressed demand has severely hurt the U.S. livestock sector**
- **What does this mean for agricultural credit conditions?**



In 2009, the farm boom is projected to end.

U.S. Real Net Farm Income



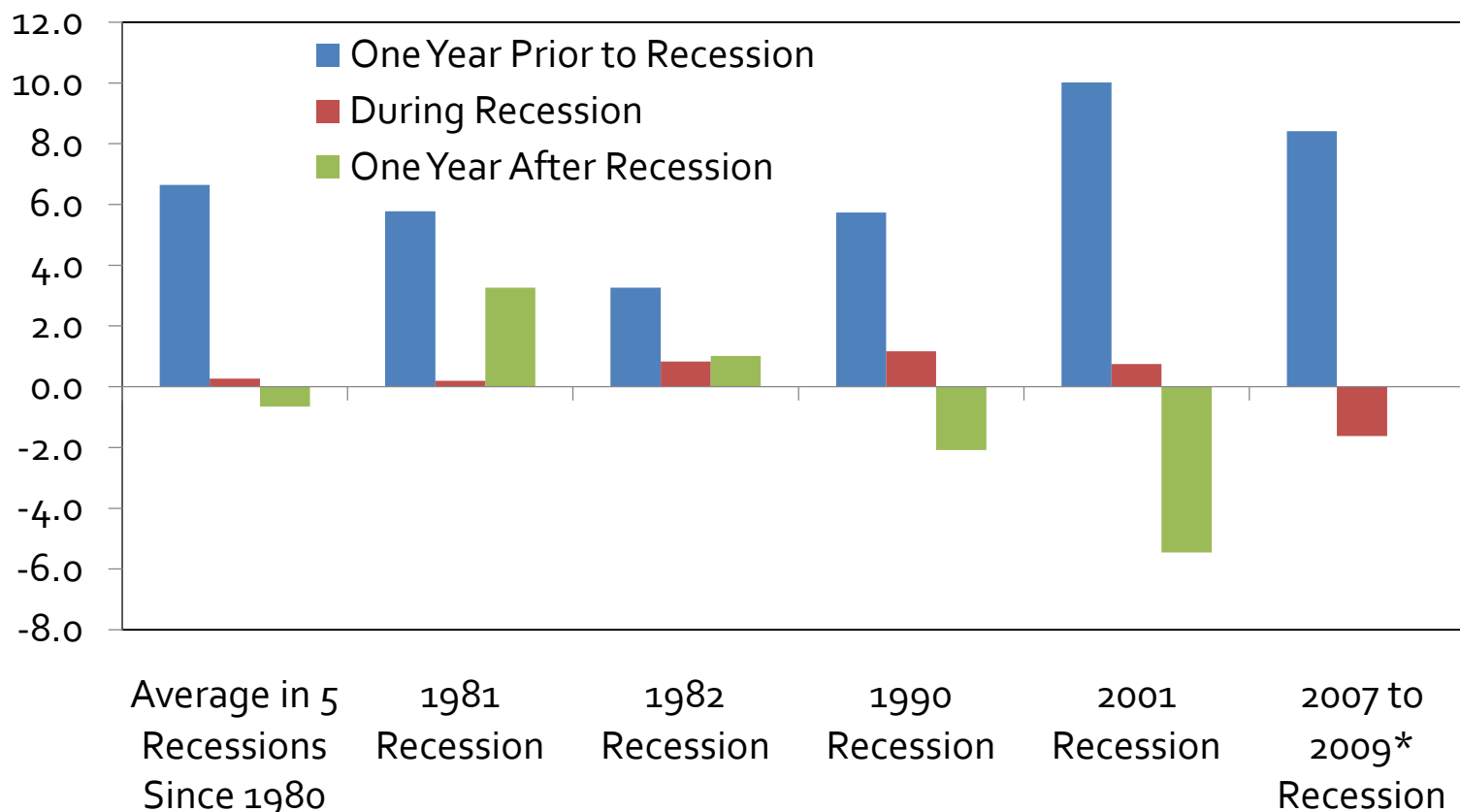
Source: USDA



Meat and milk spending tends to decline in jobless recoveries.

U.S. Per Capita Expenditures on Beef, Pork, Poultry, and Milk Products

Percent change

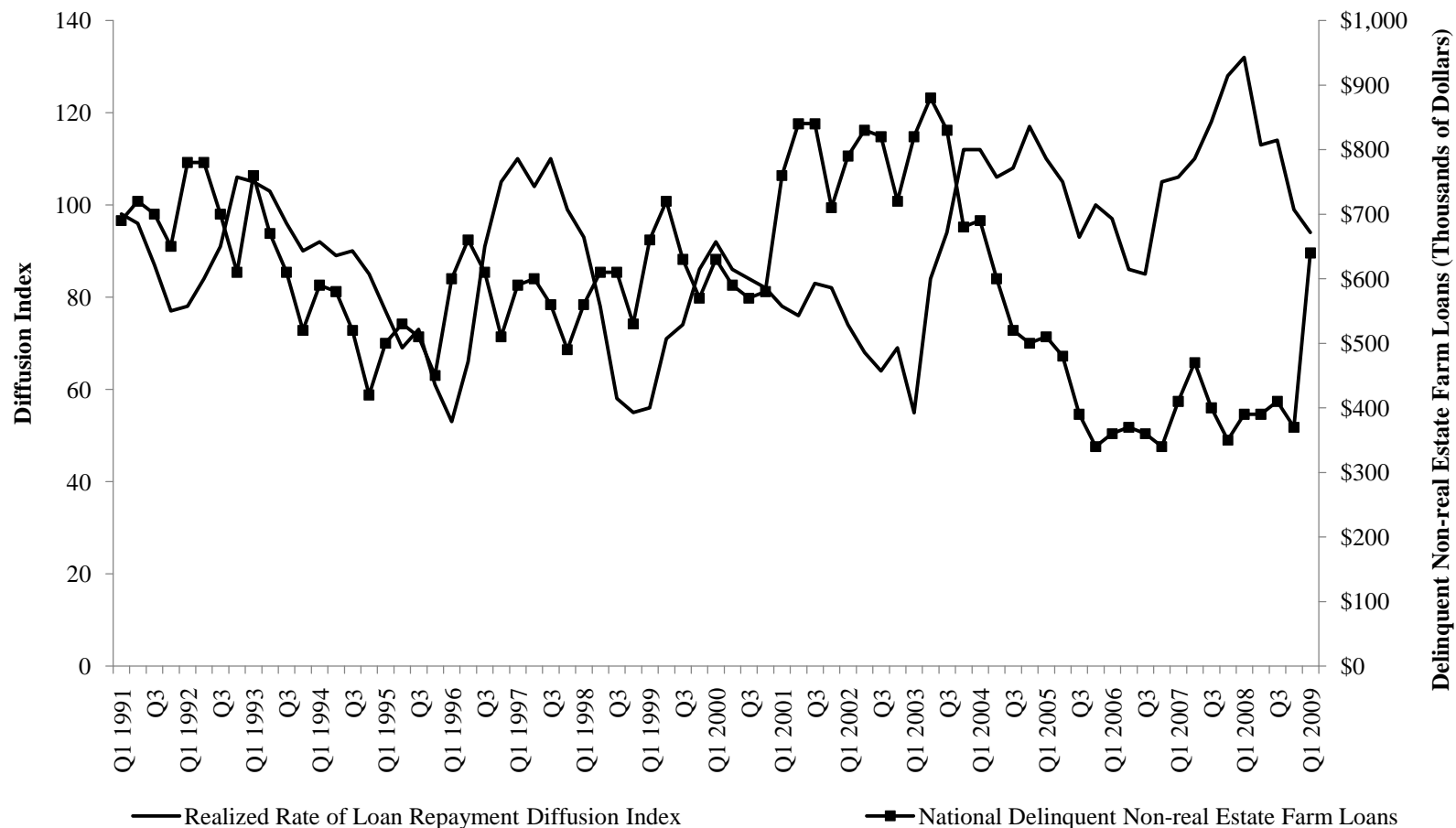


Calculations based on Bureau of Economic Analysis data

* The National Bureau of Economic Research indicates the recession started in Dec. 2007. At the time of publication, the end of the recession has yet to be specified.



What does 2010 hold for loan repayments and delinquent farm loan volume?

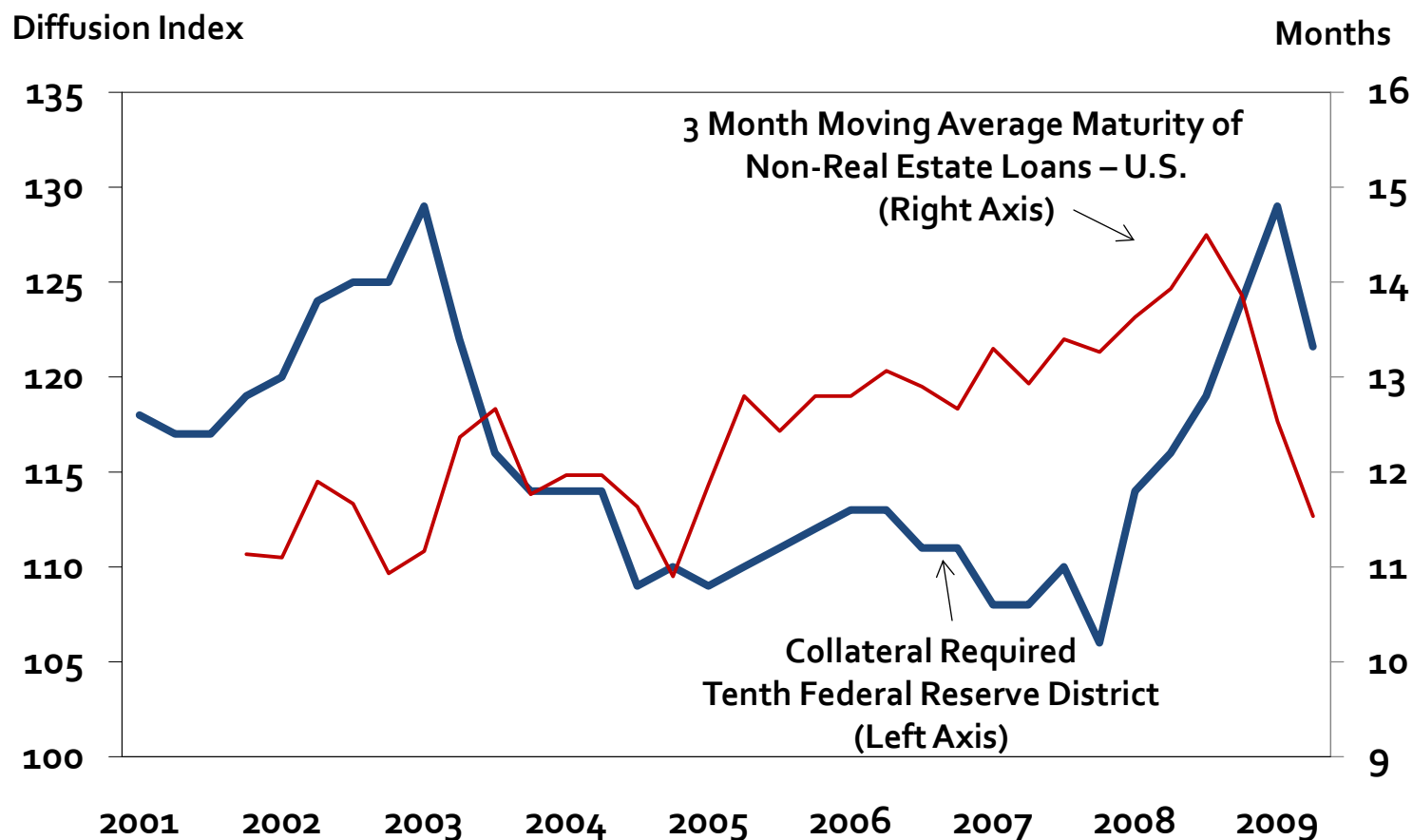


Source: 10th District Agricultural Credit Survey and Call Reports



The tightening in credit markets has slowed.

Collateral Requirements and Loan Maturity on Non-Real Estate Loans

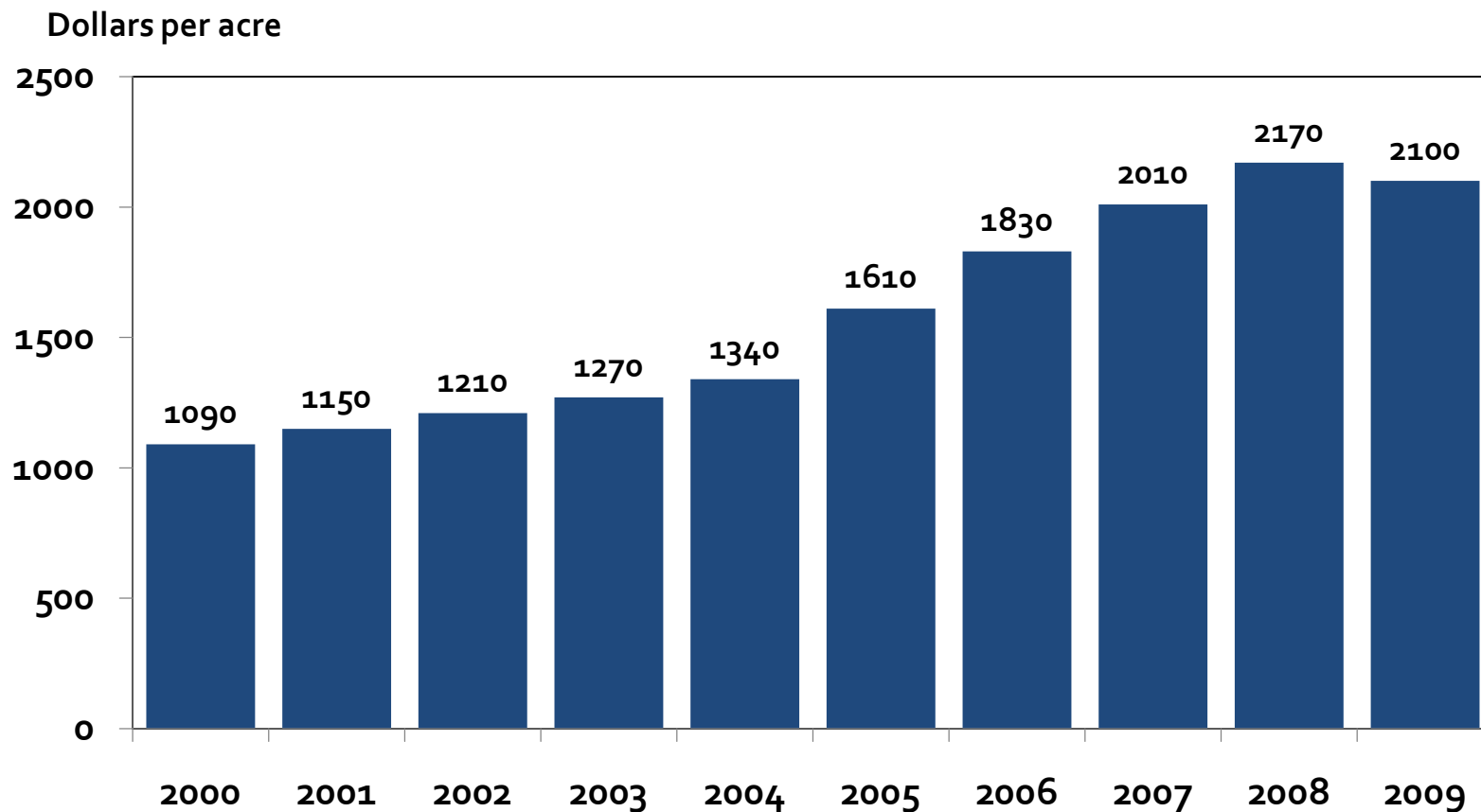


Source: Federal Reserve Bank of Kansas City and Agricultural Finance Databook



After “leveling off” in 2009, what direction will farmland values follow?

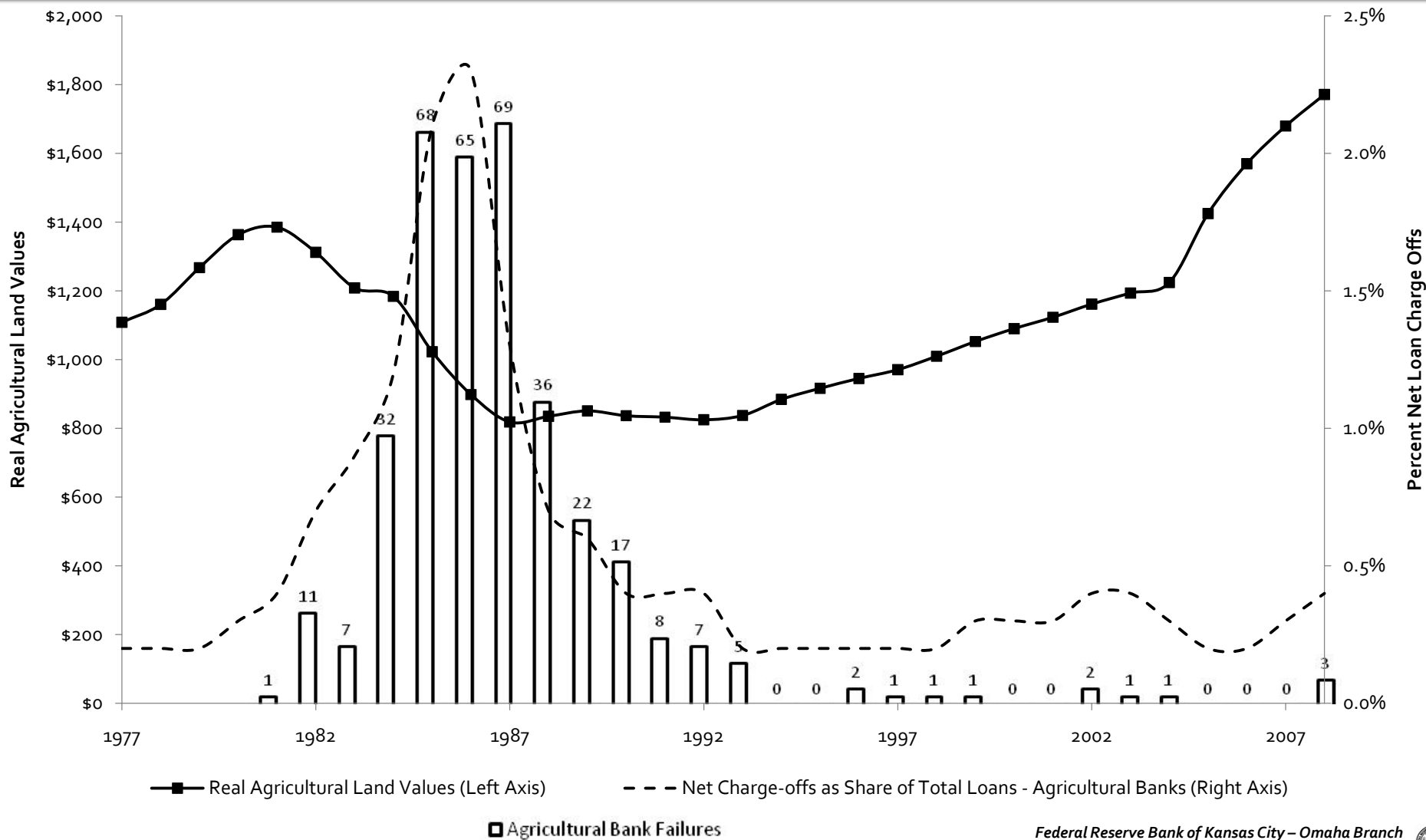
U.S. Farmland Values



Source: USDA



Historically, agricultural land values were related to much stress for agricultural lenders.



What does all of this mean for rural America?

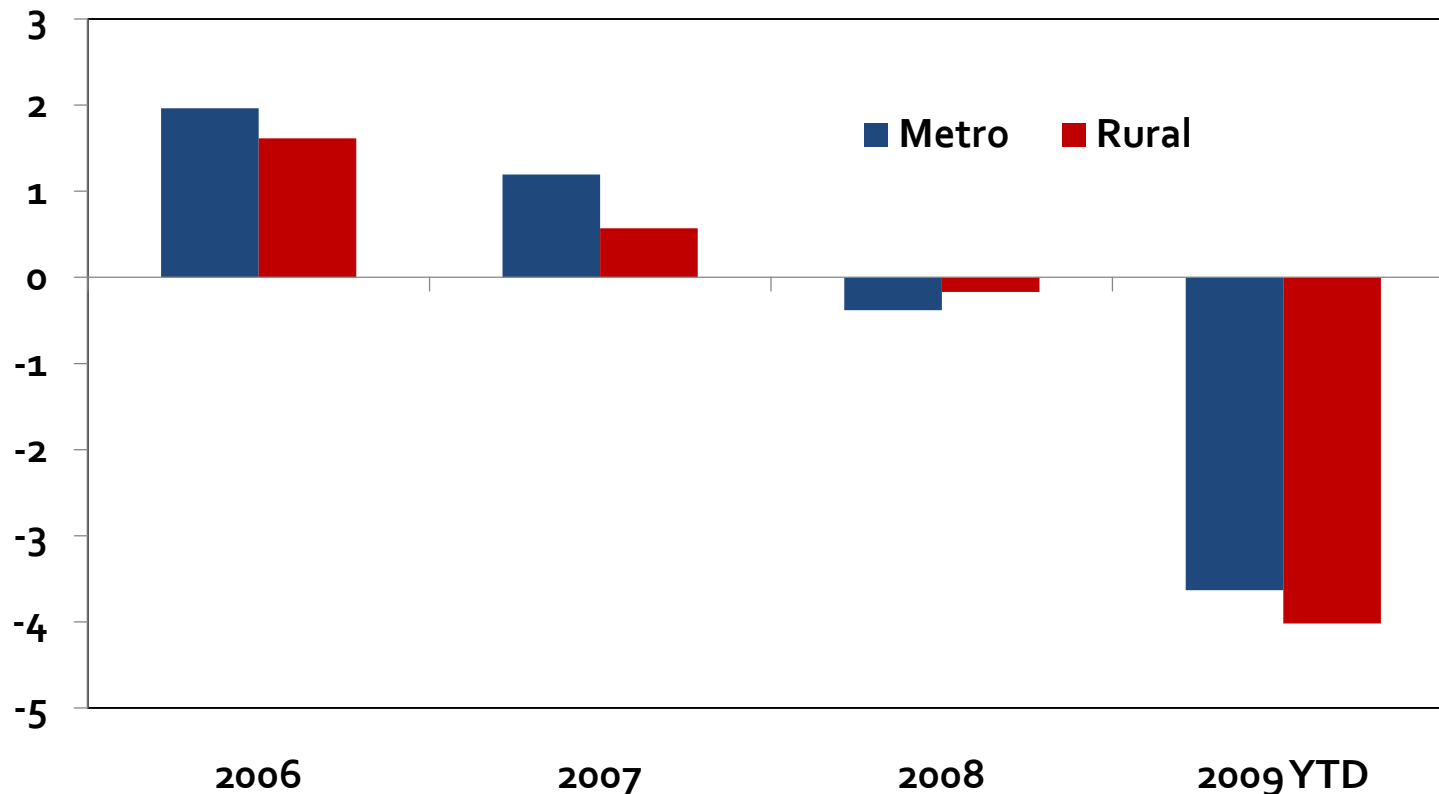
- Rural areas have not been hit as hard as metro areas
- Still, challenges exist. Where will growth come from?
 - The recovery hinges on demand.
- Continued focus on entrepreneurship, innovation, and amenities may be the best strategies for rural growth.



Strong commodity markets insulated rural communities from the early stages of the recession.

Employment Growth

Annual percent change



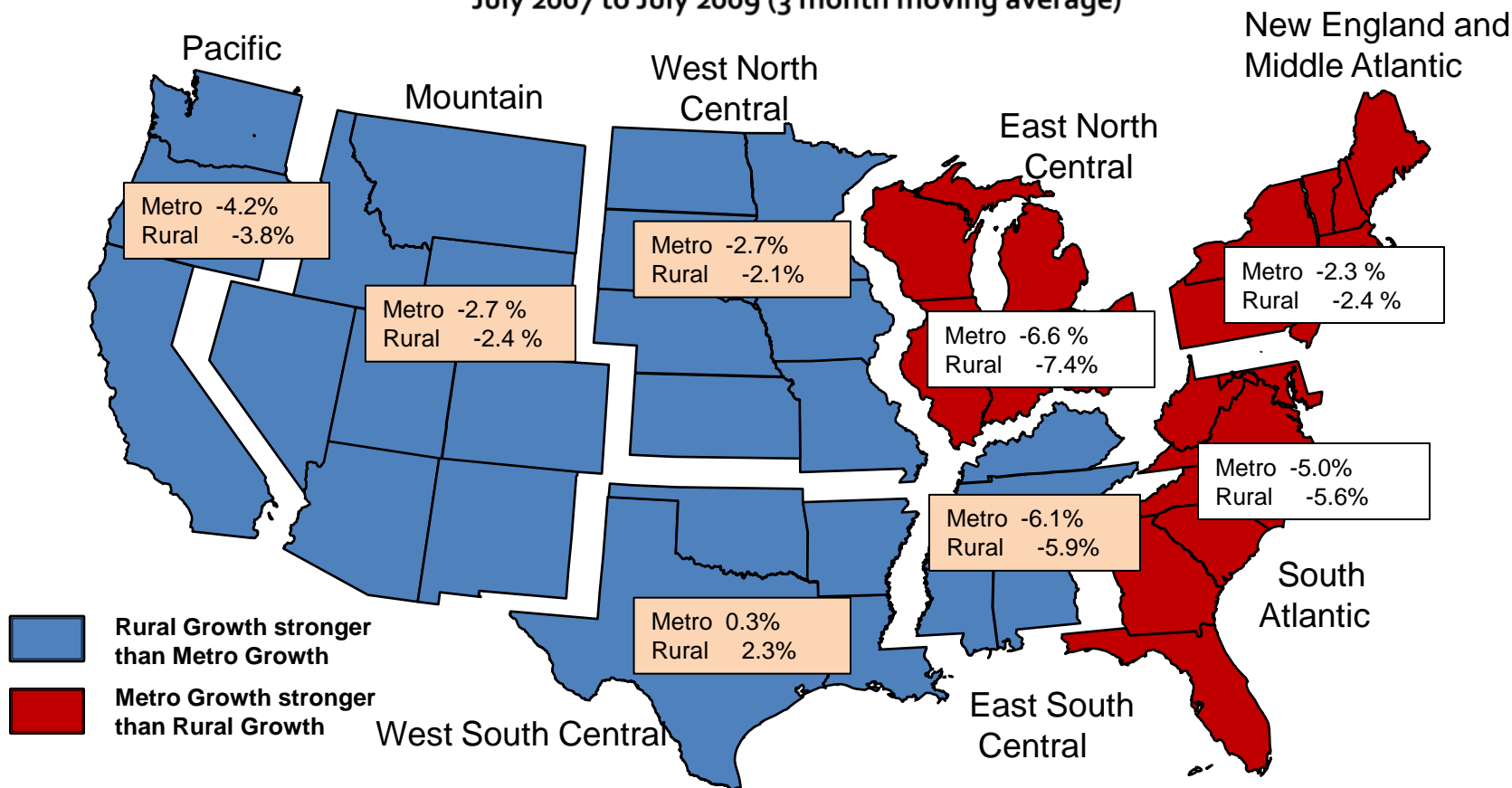
Source: Bureau of Labor Statistics
Year-to-date data through July 2009



Rural economies have held up better than metro economies in many parts of the country.

Employment Growth

July 2007 to July 2009 (3 month moving average)



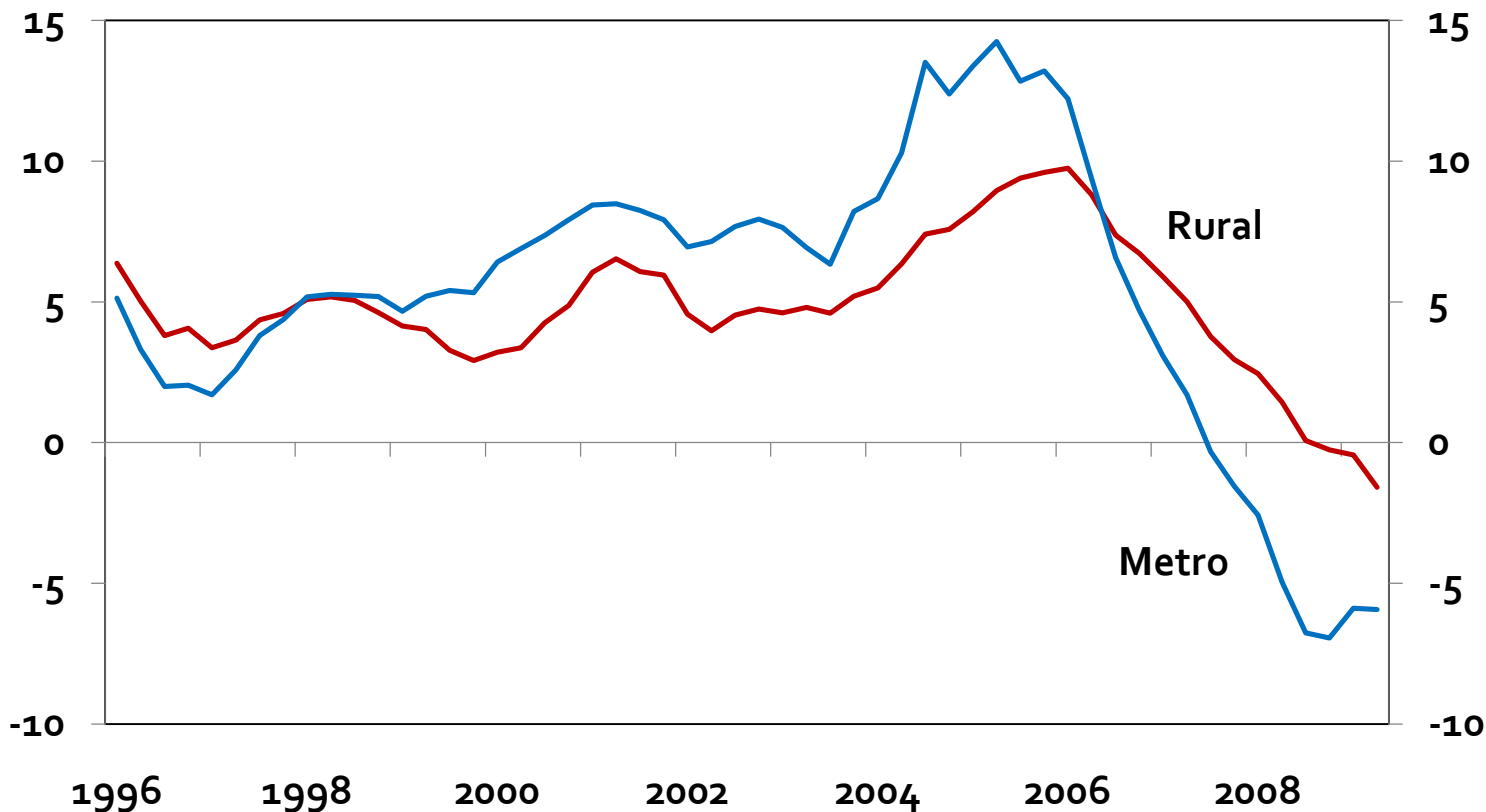
Calculations based on Bureau of Labor Statistics, LAUS data



Rural housing markets are performing better than metro markets.

Residential Housing Price Indices

Annual Percent Change



Source: FHFA and FRBKC calculations



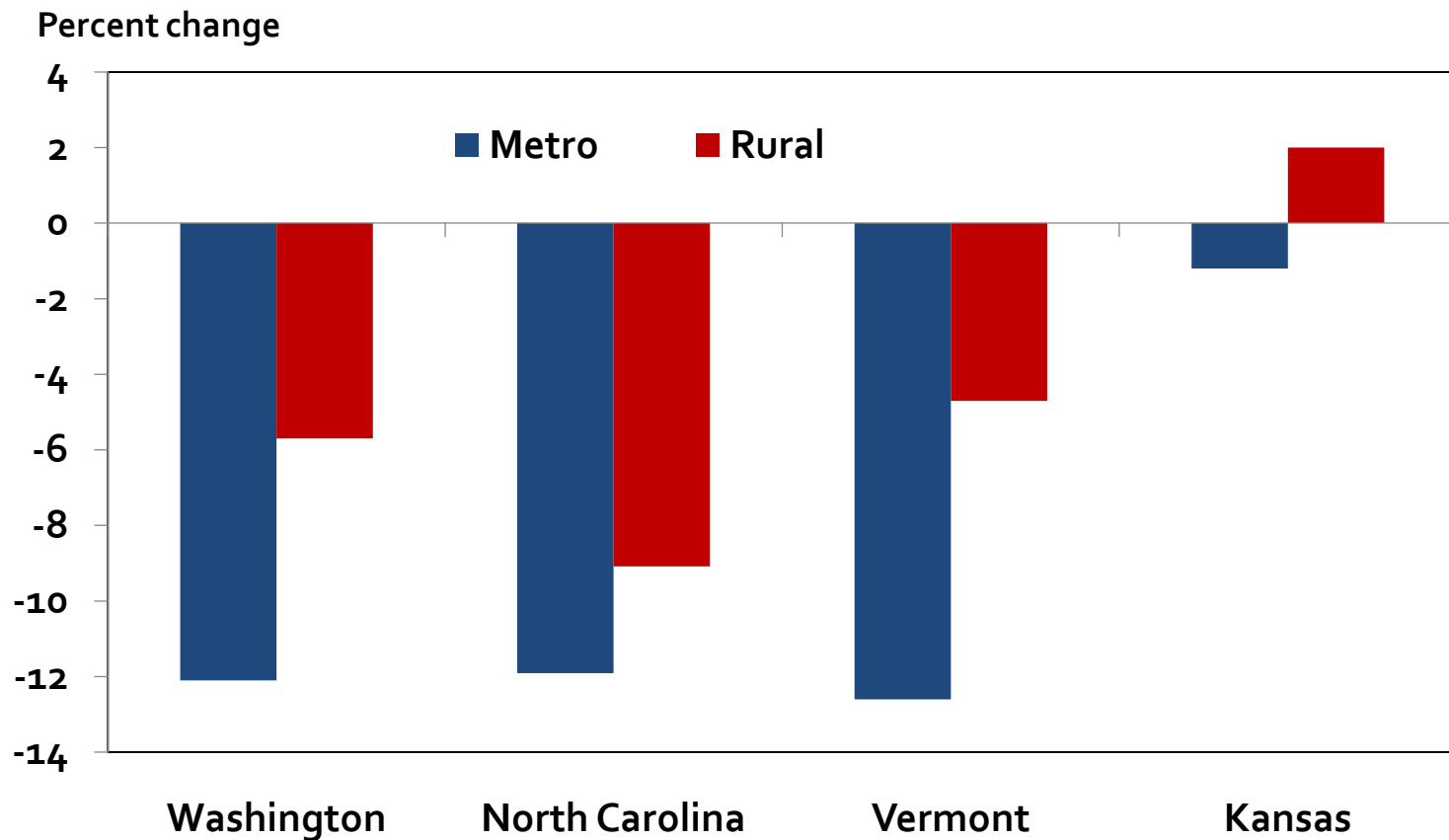
Rural financial markets are strained.

- Rural banks are performing better than metro peers.
- But, to reduce risk, banks have . . .
 - Tightened credit standards on loans.
 - Raised collateral requirements.
 - Shortened loan maturities.
- Risks remain in commercial real estate.



Consumer spending in rural places has not fallen as dramatically as in metro areas.

Retail Sales Growth 2007 to 2009

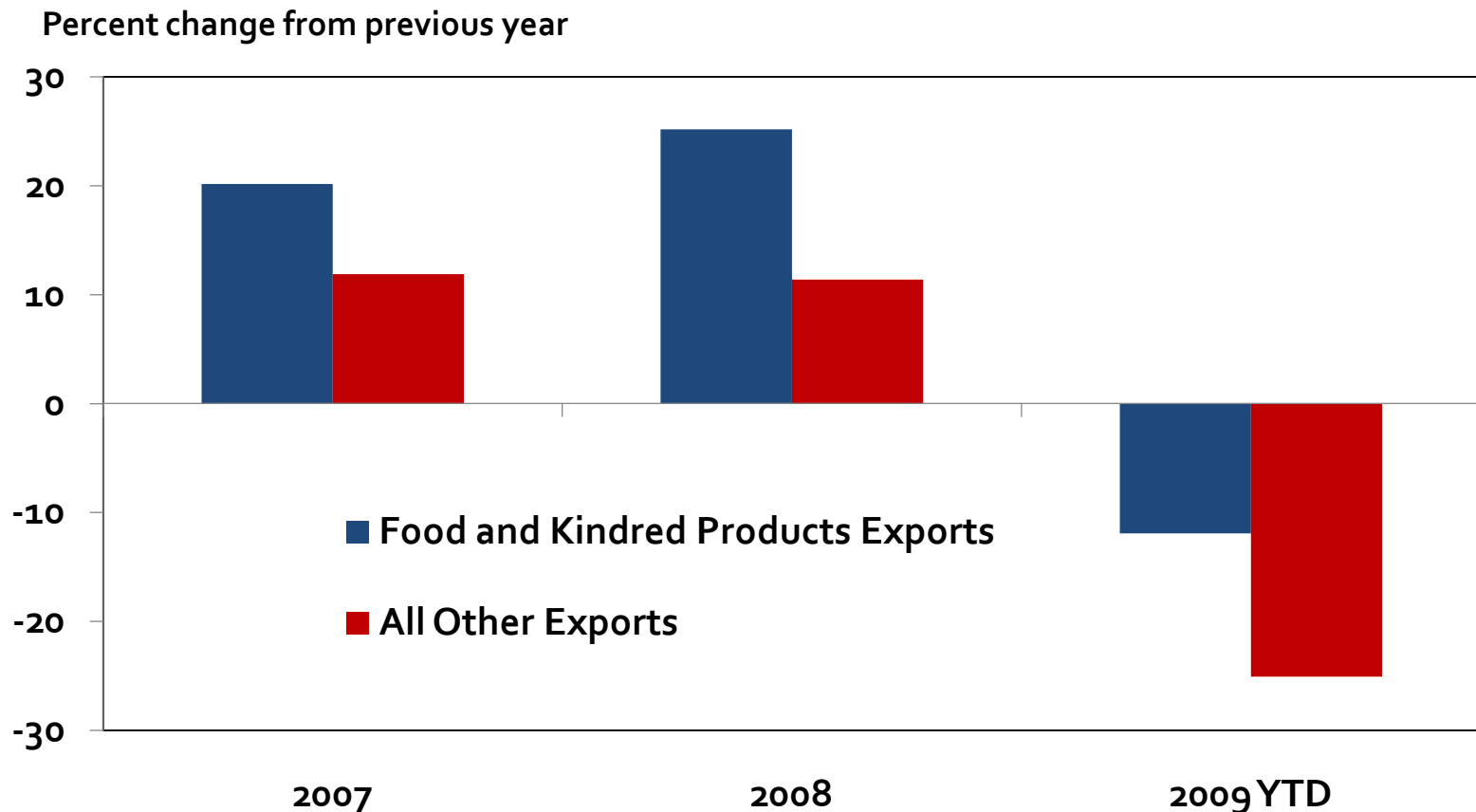


Year-to-date retail sales obtained from various department of revenues



Will processed food products drive rural export activity?

U.S. Export Growth



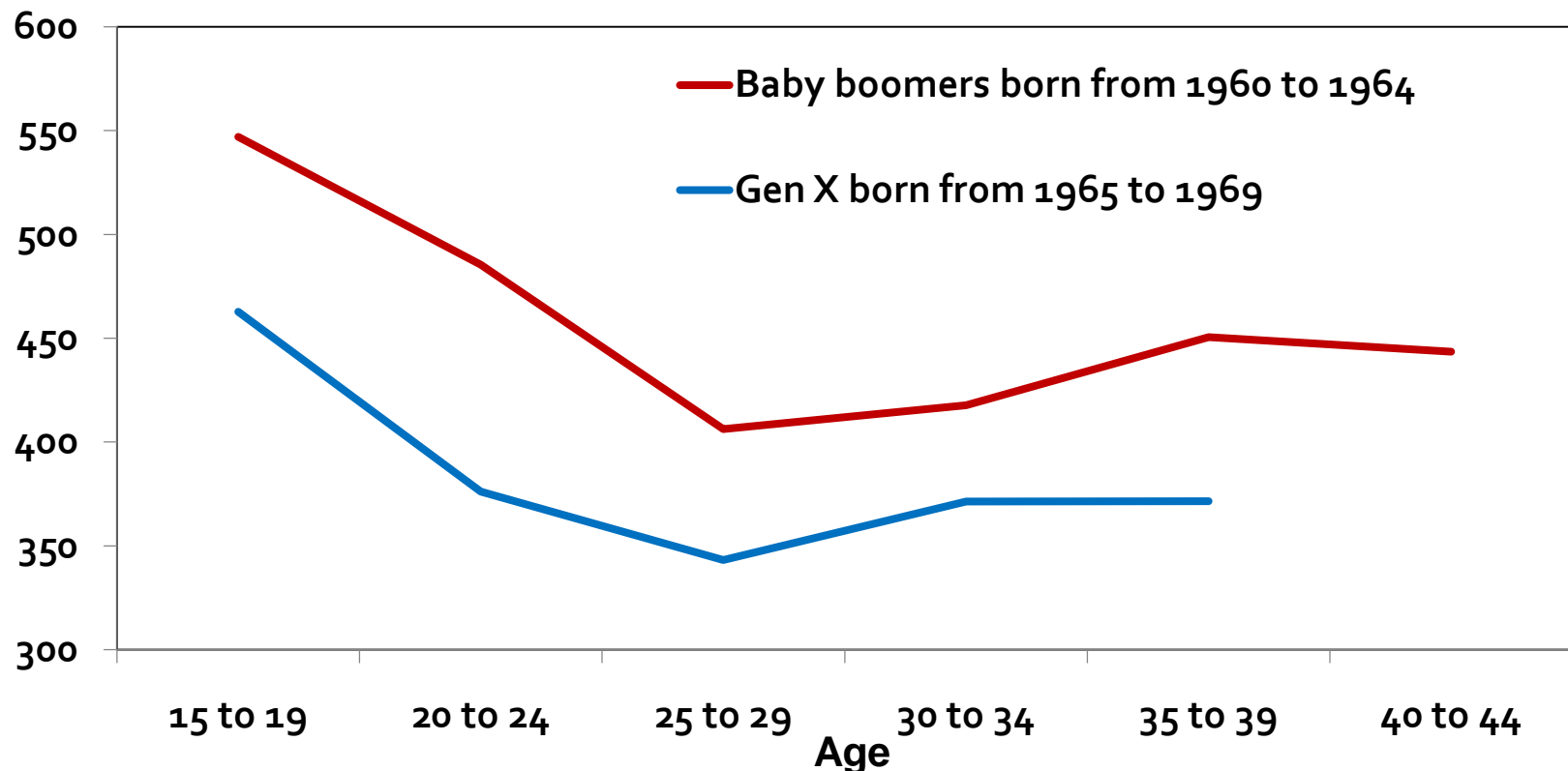
Source: WISERTrade



Will the return of middle-aged adults offer opportunities for rural communities?

Rural Baby Boomer and Gen X Population Cohorts in Kansas City Federal Reserve District

Population in Thousands



Calculations based on Census Bureau data. Rural areas are based on nonmetro county definitions. The Kansas City Federal Reserve District includes Colorado, Kansas, Nebraska, Oklahoma, Wyoming, and portions of Missouri and New Mexico.



Long-term structural challenges remain.

- Aging populations and migration challenge rural communities.
- Rising fixed production costs threaten to intensify consolidation trends.
- The financial crisis has raised deposits in rural commercial banks.
 - Will this continue?
 - Is this a permanent change or a short-term safe haven?



Conclusion

- **The financial crisis and recession appear to be ending, but risks surround the recovery.**
- **The outlook hinges on consumer spending, both in the U.S. and globally.**
- **As the recovery strengthens, questions will switch from growth to inflation.**
- **When will consumers and investors start “chasing”?**



For More Information

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Branch

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