
*Long Island Economic Outlook:
Recession Projected for 2007*

October, 2006

LONG ISLAND

U N I V E R S I T Y

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ACKNOWLEDGEMENT

The principal investigator for this report was Dr. Thomas Conoscenti, Visiting Professor, College of Management at the C.W. Post Campus of Long Island University.

LONG ISLAND ECONOMIC OUTLOOK: RECESSION EXPECTED FOR 2007

SUMMARY

In response to the Federal Reserve increasing interest rates seventeen fold since mid-2004, the decline of the mortgage refinancing boom and the significant slowdown of the housing industry, the economy is now contracting. The national economy is expected to produce a decline of GDP in 2007 by at least 0.5%.

Based on national trends, the expectation is that regional employment growth is likely to slow for the balance of 2006 and decline slightly in 2007, resulting in a mild recession in the Long Island economy in 2007. Weaknesses in the housing and construction industries along with increases in energy costs will contribute to this recession. A more severe recession could occur if a very steep drop in housing prices occurs, energy costs rise more rapidly than expected, and interest rates increase due to further tightening by the Federal Reserve or a collapse of the dollar. A terrorist attack in the U.S. could create a more critical situation by causing business and consumers to further curtail their spending.

The Long Island economy has been relatively healthy to date after experiencing a recession in 2001, a restructuring of the economy base resulting from the closing down of the Aerospace industry in the mid-nineties, the aftermath of the September 11th attacks and the economic shocks resulting from high energy prices. In the past, the defense and banking sectors played a key role, which brought the economy through the decade of the 1990's. Since 2000, the same sectors played a significantly smaller and less dominant role in the economic health of the region. In its place, the development industry, service sector and technology-oriented companies have emerged with small companies as the engines of growth.

This restructuring bodes well for the region's future by stimulating future growth in all sectors of the economy. In the short term, however, these sectors tend to be a drag on the regional economy because they lack the coordinated capital density needed to sustain the economy. Thus, the effect is that the regional economy will slowdown into a recession for Long Island by mid-year 2007 and result in at least a 0.5% decline in jobs and related wages and salaries.

NATIONAL ECONOMIC OUTLOOK: ECONOMIC ASSUMPTIONS

The national and regional economies are expected to show signs of slowing down by the close of 2006. This forecast is based on the following economic assumptions:

- Recent economic data clearly indicates that both the national and regional economies are slowing down sharply due to the cumulative impact of higher interest rates and energy prices.
- For both the national and regional economy, the main engine of economic growth over the last five years has been the housing sector. However, this is no longer the case as the housing sector is now contracting and dragging down the rest of the economy.
- Declines in the housing sector will tip the national economy into a mild recession in 2007. This will translate into a regional recession in 2007.
- Payroll employment on Long Island is expected to decline by 0.5% in 2007.
- Consumer spending should decline in 2007. Housing-related purchases, such as appliances and furniture, will be the weakest area of consumer spending.
- The forecast of a mild recession assumes that oil will hold at approximately \$65 a barrel.
- The Federal Reserve has increased interest rates seventeen fold since the summer of 2004 bringing the federal funds rate up to its current level of 5.25%. With a slowdown in the economy, no further rate increases from the Federal Reserve will take place.
- The inflation outlook remains uncertain with inflationary pressures building due to higher oil and other commodity prices. The expected CPI forecast for 2007 is 4.2%.

ECONOMY HEADING FOR A RECESSION

The last national recession occurred in 2001. Since then, the economy has expanded at a modest rate as measured by GDP. The following factors were largely responsible for driving the economy during the economic expansion:

1. An extremely expansionary fiscal policy with large tax cuts occurring in 2001 and 2003 coupled with increased government spending over the last 5 years.
2. An aggressive expansionary monetary policy that lowered the key federal funds rate to 1% in 2004.
3. Very strong consumer spending as consumers benefited from a boom in mortgage refinancing. The extra cash generated by the refinancing provided the impetus for additional growth in consumer spending.
4. Low financing costs and easy credit created a housing boom.

The problem facing the economy today is that each of the above factors is now acting as a major drag on the economy. (See Table 1 for a summary of the national and regional economic outlook.)

1. Fiscal policy is essentially neutral in its impact on the economy and no longer expansionary.
2. Monetary policy is now contracting the economy.
3. The Federal Reserve has increased interest rates seventeenfold since mid-2004, pushing the federal funds rate to 5 ¼%. The cumulative impact of these rate hikes is now adversely influencing the economy.
4. The mortgage refinancing boom is over.
5. The housing sector is showing signs of a significant slowdown.

Table 1 ECONOMIC OUTLOOK SUMMARY

National Economic Outlook			
	2005	2006	2007F
Real GDP	3.5%	2.6%	-1.0%
Consumer Spending	3.5%	2.1%	-0.3%
Unemployment Rate	5.1%	4.9%	5.6%
CPI inflation	3.4%	3.7%	3.0%
3-month Treasury Bill	3.1%	4.8%	4.5%
10-year Treasury Note	4.3%	5.0%	5.2%
Nassau- Suffolk Economic Outlook*			
Payroll Employment (% change)	0.5%	0.4%	-0.5%
Unemployment Rate	4.1%	4.3%	4.9%
NY metro area CPI	3.9%	5.0%	4.2%

HOUSING WEAKNESS WILL TIP THE ECONOMY INTO A RECESSION

Housing has played a critical role in the current economic expansion. About 30% of the employment growth nationally over the last 3 years was directly due to housing. The direct effects of the housing sector are the jobs in new construction, renovations, and remodeling, building materials, mortgage brokerage and real estate sales. The indirect effects of housing are also critical and lead to spending on home appliances, furniture, and other household-related goods. In addition, the wealth effect associated with higher housing prices further increases spending on goods and services.

Every indicator of the housing market released over the last few months demonstrates that the housing sector is declining:

- Sales on new homes are down 21.6% over the past year and inventories of unsold homes are at an 11-year high.
- Existing home sales declined in July, 2006 to a two-year low. Inventories of existing homes are at a record 7.3-month supply.
- Housing starts have declined for five straight months and are down over 13% on a year-over-year basis.
- The homebuilders' confidence index is at a 15-year low.

- Construction spending declined by 1.2% in July coupled with a sharp drop in private construction. The index is now down 16% over the last 12 months.

HURDLES TO GROWTH

Other than a weakening housing sector, the economy faces other hurdles:

- Oil prices remain very high at approximately \$65 a barrel.
- Interest rates have increased significantly since mid-2004.
- Debt service costs for millions of homeowners will increase this year and next.
- An estimated \$1 trillion in adjustable rate mortgages will reset this year and an additional \$1.8 trillion will reset in 2007. Thus, the higher mortgage payments will further restrain consumer spending.
- The consumer debt burden has risen while the savings rate is negative.
- After adjusting for inflation, wage growth has been stagnant.

OTHER INDICATORS

Other indicators clearly show that the national economy is slowing:

- August, 2006 chain store retail sales were disappointing (Down).
- Consumer confidence declined sharply in August, 2006 (Down).
- The index of leading indicators points to a significant slowdown in the economy over the next few months (Down).
- Job growth was relatively lackluster over the last 3 months.
- Average weekly work hours declined in August, 2006 (Down).
- Factory orders declined in July, 2006 (Down).
- Weak inflation- adjusted income growth occurred (Down).

ECONOMIC FORECAST

Given the above trends, the national economy is expected to contract in 2007. Led by a contraction in the housing sector, the GDP is expected to decline by at least 0.5% in 2007.

On the inflation front, the outlook remains uncertain. High energy and commodity prices, slowing productivity and some upward pressure on wages suggest some inflationary pressures in the year ahead.

LONG ISLAND ECONOMIC OUTLOOK

The Long Island economy expanded at a modest rate in 2005 and for the first half of 2006, a slower pace than evident in 2004. Nassau-Suffolk gained 5,700 jobs in 2005 or 0.5%, to a level of 1,240.6 million jobs in the 12-month period ending in December 2005 when compared to the same period during the prior year, when the region gained 11,100 jobs in 2004.

Job growth for the first seven months of 2006 has remained modest. The region gained 7,300 jobs in the 12-month period ending in July, 2006. Most of the job gains were in the service sector and in local government. Job losses occurred in manufacturing and in wholesale trade. Jobs in the real estate sector were down by 2.7% or 500 jobs. The unemployment rate in Nassau-Suffolk was 4.4% in July 2006 compared to 4.3% in July, 2005.

Table 2 shows the trend in employment since the year 2000. It is evident that employment growth in the region has slowed compared to the pace of growth in 2003. Table 3 shows the year-over-year change in employment for July 2006. The key question is whether the modest trend in employment growth will continue into 2007.

Based on national trends the expectation is that regional employment growth is likely to slow for the balance of 2006 and decline slightly in 2007 resulting in ***a mild recession in the regional economy in 2007.***

Weakness in the housing and construction industries will pull down the rest of the economy in 2007. Construction is a critical industry on Long Island. Over the last year, over

20% of the jobs created on Long Island have been in construction. This does not account for the indirect impact on spending for household appliances and furniture and other consumer goods.

Table 2
LABOR MARKET TRENDS
NASSAU-SUFFOLK

Year	Change in Nonfarm Payroll Jobs	Unemployment rate
2006*	7,000	4.2%
2005	6,700	4.1%
2004	11,100	4.6%
2003	7,300	4.8%
2002	-3,100	4.7%
2001	600	3.8%
2000	27,800	3.4%

*Average of first half of the year

Table 3
CHANGE IN NON-FARM JOBS BY INDUSTRY
NASSAU SUFFOLK
(JULY 2006- JULY 2005)

Industry:	Net Change	% Change
Total, Non-farm jobs	7,300	0.6%
Private sector	5,700	0.5%
Construction	1,600	2.3%
Manufacturing	-1,000	-1.2%
Wholesale trade	-1,200	-0.8%
Retail trade	700	0.4%
Information	0	0%
Financial Activities	-1,300	-1.6%
Prof. & Bus. Services	1,800	0.4%
Educ. & Health Services	1,700	0.9%
Leisure & hospitality	1,700	1.6%
Government	1,600	0.8%

REGIONAL FORECAST ECONOMIC ASSUMPTIONS

The Long Island economic forecast is based on the following economic assumptions:

- Regional economy is weakening due to the cumulative impact of higher interest rates and energy prices.
- For both the national and regional economy, the main engine of economic growth over the last four years has been the construction and housing industries. This is no longer the case as the housing sector is now contracting and dragging down the rest of the economy.
- The declines in new housing starts and housing prices will likely contribute to a regional recession in 2007.
- Payroll employment on Long Island is expected to decline by 0.5% in 2007.
- Consumer spending should decline slightly in 2007. Housing-related purchases such as appliances and furniture will be the weakest area of consumer spending.
- The forecast of a mild recession assumes that oil will hold at approximately \$65 a barrel.
- The Federal Reserve has increased interest rates seventeen times since the summer of 2004 taking the federal funds up to its current level of 5.25%. With the economy slowing, no further rate increases are expected from the Federal Reserve.
- CPI at the regional level will increase at a 4.2% rate in 2007, somewhat less than in 2006 when soaring oil prices led to some pricing pressures.

RISKS TO THE FORECAST

It is expected that the economy will experience a mild recession in 2007. A more severe recession is likely if the following occurs:

1. Rising housing prices have fueled the growth in mortgage borrowing and enabled consumers to spend at high rates relative to their income. A sharp drop in housing prices would cause consumers to cut spending resulting in a further slow down the economy.
2. It is expected that oil prices will stay around \$65 a barrel in 2007. If oil prices rise significantly above \$65 a barrel, the economy will be adversely impacted.
3. If inflationary pressures continue to build in the economy, the Fed may be forced to raise rates, further slowing down both the national and regional economy.
4. Large current account deficits could result in a collapse of the dollar. This would result in a sharp rise in interest rates and significantly weaken business investment.
5. A terrorist attack in the US would weaken the economy and further cause business and consumers to curtail their spending.

CONCLUSION

Given the wave of statistical data and indexes pointing in the same direction, the Long Island economy will face a recession in 2007.