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The Increasingly Uncertain U.S. Economy:

ITS IMPACT ON THE LONG ISLAND ECONOMY

The U.S. economy may be significantly weaker than it once appeared and there are indications that it may be decelerating more than expected. Although the ongoing weakness in housing has been offset by relatively strong job growth and increased exports, there is some concern that mounting mortgage defaults among subprime borrowers could eventually lead to a more generalized "credit crunch". This article analyzes recent changes in U.S. business conditions and discusses their potential impact on the Long Island economy.

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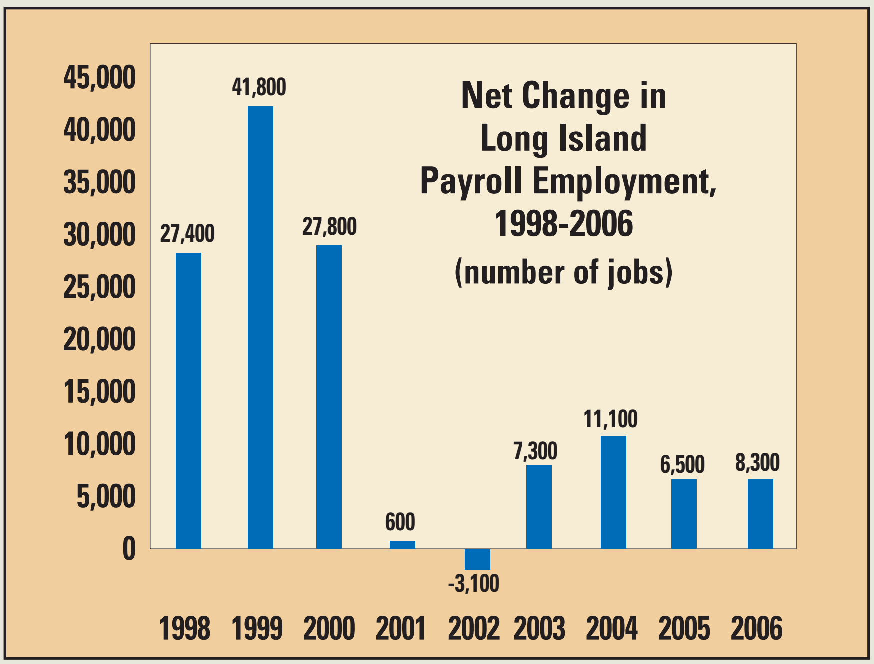
The National Economy



According to the U.S. Federal Reserve, economic activity is growing modestly in most parts of the country but has started to slow in the Northeast. The Fed's "beige book", an anecdotal summary of regional business conditions, showed that continued demand for skilled workers is pushing up wages and that, with the possible exception of New York City, housing markets remain weak across the country. The downward revision in fourth quarter 2006 GDP from 3.5 percent to 2.2 percent confirmed that the economy is growing at a sub-par rate. The Federal Reserve left the overnight Federal funds rate unchanged at 5.25 percent at its March meeting amid indications of continued economic weakness during the first quarter of this year. However, it dropped its bias toward raising rates rather than lowering them. This led to expectations that the Fed might actually consider a rate cut at its June meeting, should the economy slow further. This may be wishful thinking given the Fed's ongoing concern about inflation.

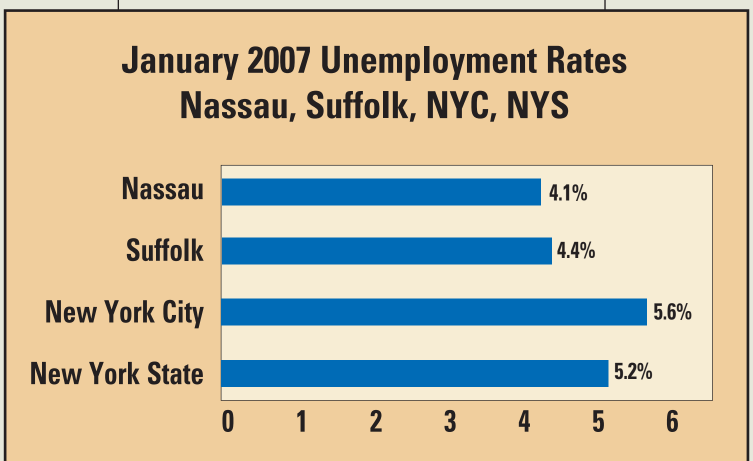
Until recently, economists were confident that the housing slump would not spill out into the general economy. That view is beginning to change as mortgage defaults among sub-prime borrowers escalate. According to a recent report from the Mortgage Bankers Association, a record number of homes entered the foreclosure process in the fourth quarter of last year and there has been a weakening in credit quality across-the-board. Today's foreclosure problems reflect the growing use of exotic home loans that permitted buyers with less than stellar credit to purchase homes during the recent housing boom. Such home purchases often involved little or no down payments or proof of income.

The teaser interest rates on many of these mortgages have expired and significantly higher monthly mortgage payments have led to a wave of loan defaults. The default rate on sub-prime mortgages has reached 13 percent and is still climbing. It is estimated that 1.1 million foreclosures could result from defaults on sub-prime mortgage loans made between 2004 and 2006. More worrisome is the fact that some financial institutions have begun to report credit problems among more credit-worthy borrowers.

These mortgage defaults are also hurting investors. In recent years, mortgages have been pooled based on quality, packaged and then sold as derivative securities to individual investors, pension funds, insurance companies and hedge funds. Mortgage-backed securities have been traded since the 1970s but have been widely sold as investments only since 2002. It is estimated that 35 percent of all mortgage-backed securities issued last year were backed by sub-prime mortgages.

Mortgage lenders are now tightening loan standards, which will reduce the number of buyers who qualify for mortgages just as a wave of defaulted properties hits the market. This could create a "perfect storm" within the housing market. A record number of homes for sale coupled with significantly fewer potential buyers could lead to even steeper home price declines. If credit problems in the housing market create a more generalized credit crunch, which seems unlikely at present, today's housing market problems could spill over into the general economy.

The housing recession has been offset to some extent by a relatively robust job market. Preliminary figures indicate that the U.S. economy added 97,000 payroll jobs in February and that the U.S. unemployment rate slipped from 4.6 percent to 4.5 percent. The tighter labor market has led to more rapid wage increases, which are helping to support consumer spending. The wages of non-managerial workers increased by 4.1 percent in the twelve months ending in February, which is significantly faster than the rate of consumer inflation. However, there was also some bad news in the February employment numbers. Only 60 percent the new payroll jobs occurred in the private sector. The government sector accounted for 40 percent of new job growth. Therefore, private-sector jobs grew more slowly in February than at any time since November 2004. The growth in worker productivity has also slowed. Productivity, defined as output per hour, rose by only 1.6 percent in 2006, significantly slower than in the prior decade. As a result, unit labor costs grew at their fastest rate in six years. If productivity growth continues its three-year slide, household wealth will suffer and inflation will escalate.



Increased exports are also helping to offset the recession in housing. Last year, exports contributed more to GDP growth than the sluggish housing market took away. Exports are expected to continue to increase for the foreseeable future because economic growth abroad is stronger than domestic economic growth. The global economy expanded by an estimated 5.3 percent in 2006 and is projected to increase by 4.9 percent this year. As a result, net exports should contribute to the growth of real U.S. GDP this year for the first time since 1995.

The prospect of increased exports is good news for the nation's trade deficit, which has ballooned over the past decade. It reached $764 billion in 2006, a new record. Both the bill for oil imports and America's trade deficit with China also set new records last year. The deficit continues to pose potential problems for the U.S. economy because it is being financed primarily with foreign borrowings. Foreign capital currently accounts for more than 6 percent of U.S. GDP. During 2006, America needed an average of more than $70 billion monthly from abroad to finance its current account deficit. Foreign lenders are beginning to diversify their foreign exchange reserves away from dollar-denominated assets. China plans to diversify $200 billion of its $1 trillion in foreign exchange reserves, which will put further downward pressure on the U.S. dollar. The dollar has already declined in value by 27 percent since early 2002 against a market basket of foreign currencies. Long-term U.S. interest rates may also have to increase because a higher return on U.S. securities will be needed to attract foreign capital. The current return on U.S. securities is low relative to investment opportunities elsewhere. Higher long-term interest rates would harm the U.S. economy at a time when its underpinnings have become more fragile.

The Economic Outlook. Although the "R" word has once again crept into the economic lexicon, most analysts expect continued sub-par economic growth rather than an outright recession. Monetary policy remains loose by historical standards, long-term interest rates are close to their historical lows and the dollar is relatively cheap in foreign exchange markets. And, although mortgage-lending standards are tightening, commercial bank credit is expanding at a 9.8 percent annual rate, which should provide adequate liquidity to the economy. Real consumer incomes are rising and consumer spending is expected to grow by about 3 percent in the first quarter of this year.

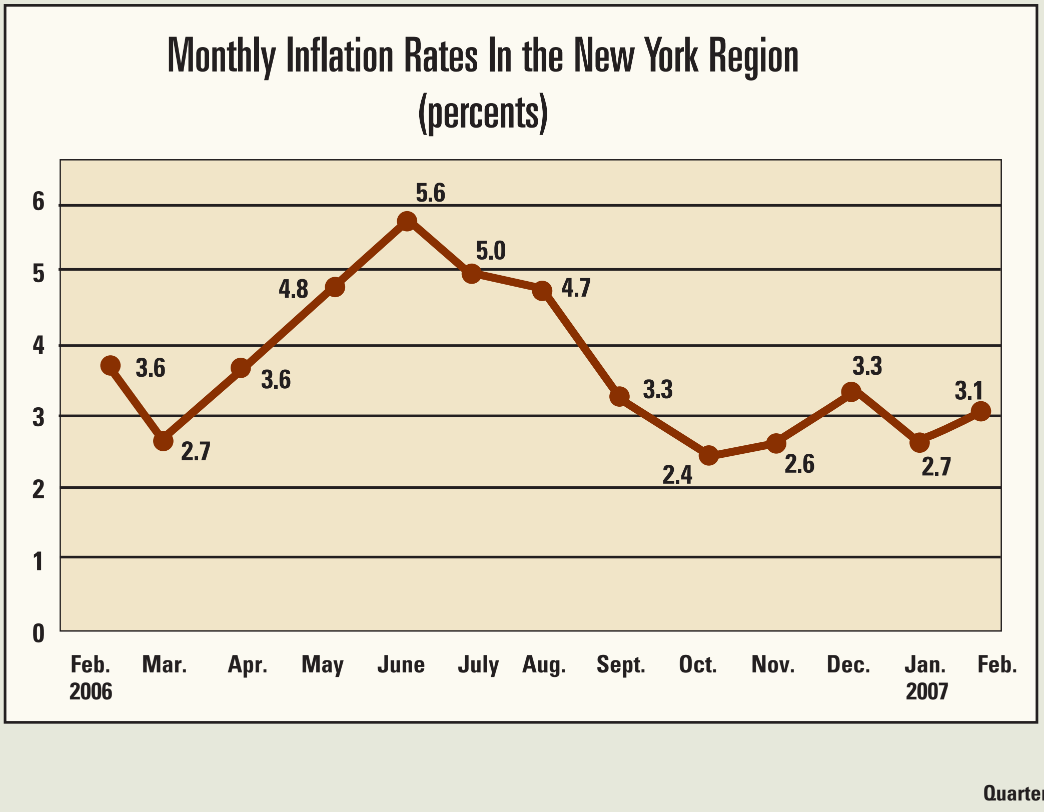
The Net Change in Long Island Non-Farm Jobs, 1998-2006

Year	Average Annual Jobs	Net Change From Previous Year
1998	1,148,400	27,400
1999	1,190,200	41,800
2000	1,218,000	27,800
2001	1,218,600	600
2002	1,215,500	-3,100
2003	1,222,800	7,300
2004	1,233,900	11,100
2005	1,240,400	6,500
2006	1,248,700	8,300

Source: New York State Labor Department

Recent increases in unit labor costs and energy prices suggest that inflation remains a more imminent threat to the economy than recession. Wholesale prices surged by 1.3 percent in February, driven by big increases in energy prices and food costs. Consumer prices rose by 0.4 percent in February, twice as fast as January's increase. Although construction of new homes and apartments rose by 9 percent in February, building permits continued to decline, a signal of more trouble ahead in the construction industry. The potential loss of business confidence is another area of concern. Business investment has been less robust than anticipated despite the fact that most businesses continue to enjoy solid profits and strong balance sheets. If the business sector becomes more risk averse in today's increasingly uncertain economy, both business capital spending and hiring could suffer. This would make the economy more prone to recession.

It is hoped that a resilient labor market and a resilient consumer will keep the economy out of negative territory as the housing bubble unwinds and its financial consequences play out. The Federal Reserve projects real GDP growth of about 2.75 percent this year.



However, the downside risks are beginning to multiply.

The Long Island Economy

Long Island is not creating as many jobs in this economic recovery as in past business recoveries. Nassau and Suffolk Counties gained only 8,300 non-farm payroll jobs last year, when compared with more than 27,000 new jobs annually during the late 1990s. Moreover, industries such as finance, trade and information, once major Long Island job generators, are now experiencing minimal job growth or outright job losses. Last year, the only significant job growth occurred in professional, scientific and technical services and in educational and health services, industries that accounted for 80 percent of total job growth. There is tentative evidence that the pace of job growth on Long Island has accelerated in recent months. January 2007 data show a year-to-year employment gain of 16,900 payroll jobs. Long Island continues to have a full-employment economy with a January unemployment rate of 4.1 percent. Comparable January rates were 5.3 percent in New York City and 4.9 percent in New York State.

Long Island's sluggish job market is partly related to the mismatch between home prices and household incomes on Long Island. The recent housing boom pushed home prices to unaffordable levels. As a result, many young people have left Long Island, taking their skills with them. This is why local employers often have difficulty in finding skilled workers to fill available job vacancies. Hence, the slow pace of job growth.

Housing prices are now declining in both counties. According to the Multiple Listing Service of Long Island, the median price of newly sold Nassau homes was $460,000 in February, 8 percent below year-ago levels. The comparable Suffolk median was $379,000, one percent less than a year ago. These relatively modest declines suggest that Long Island's housing bubble is deflating gradually and not imploding. However, a significant number of recent purchasers utilized sub-prime mortgage instruments to buy a home in Long Island's superheated housing market. Many face significantly higher monthly mortgage payments and some are likely to default on these mortgages. Therefore, the sub-prime mortgage crisis may be more pronounced on Long Island than elsewhere. There are already a large number of homes for sale on Long Island and this inventory would increase if there are significant mortgage defaults. The Multiple Listing Service estimates that almost 8,700 Nassau homes and 12,800 Suffolk homes were for sale in February. This is equivalent to a 9.2-month supply in Nassau and a 12.2-month supply in Suffolk. Long Island's growing inventory of homes for sale is likely to further depress home prices.

Recent Trends in Sales Tax Revenues (Percent Change from Previous Year)

Year/Month		Nassau	Suffolk	Nassau-Suffolk
2005:	October	6.7	7.9	7.3
	November	2.7	3.1	2.9
	December	8.7	3.7	5.9
2006:	January	-3.2	-0.1	-1.6
	February	4.2	7.2	5.8

Source: New York State Department of Taxation & Finance

Consumer spending, as indicated by trends in sales tax revenues, has held up reasonably well on Long Island. This is good news for Nassau and Suffolk Counties, which derive at least half of their tax revenues from the sales tax. December sales tax revenues increased by 5.9 percent when compared with year-ago levels. Consumers took a breather in January but returned to the malls in February. February sales tax revenues were 5.8 percent above year-ago levels, which is significantly higher than the regional inflation rate of 3.1 percent. The delayed use of holiday gift cards may be responsible for the surge in consumer spending in February. Large year-end Wall Street bonuses may also have contributed to high-end consumer purchases.

Long Island's Economic Outlook. The future course of economic activity on Long Island depends in large measure on the strength of consumer spending, which accounts for approximately two-thirds of overall economic activity. Long Island's full employment economy and the wage increases it generates should help to sustain a moderate level of consumer spending. The big unknown is what will happen to energy prices. Rising gasoline prices could again take a toll on bi-county consumer spending as it did in the middle of last year, when prices exceeded $3 a gallon. Tight supply-demand conditions in global oil markets will cause continued volatility in energy prices. It remains to be seen whether Long Island's tight labor market will push up wages enough to offset the drag on consumer spending created by higher energy prices and declining home prices.