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SPURRING ECONOMIC GROWTH ON LONG ISLAND AS THE U.S. ECONOMY SLIPS INTO RECESSION

As the economic storm clouds continue to gather, it seems likely that the nation is slipping into recession. Today's economic problems are concentrated in the credit and housing markets, which means that all regions will suffer to some extent. This may be the time to look beyond the current period of economic weakness and focus on policy solutions that will ensure greater regional competitiveness once an upturn begins. This article analyzes current economic conditions nationally and on Long Island and explores the economic development initiatives that could improve Long Island's future economic competitiveness.



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The National Economy

The U.S. economy is experiencing a combination of slowing economic growth and rising inflation that is reminiscent of the "stagflation" of the 1970s. With both the manufacturing and service sectors contracting, employers eliminated 63,000 jobs in February and 22,000 in January. Such back-to-back losses tend to occur around recessions.

It has become clear that credit market turmoil and falling home prices have taken a significant toll on the economy. Home prices are falling in virtually every region. Average home prices are expected to fall by at least 20 percent from their 2006 peak before the housing market stabilizes. Declining home prices are reducing household wealth. According to the Federal Reserve, net household wealth declined by \$900 billion in the fourth quarter of last year. Moreover, 30 percent of all homeowners who purchased their homes in 2005 and 2006 are estimated to have "negative equity". This means that their mortgages are larger than the resale value of their homes.

The housing meltdown has triggered widespread credit market

problems. Mortgage defaults and delinquencies are accelerating. The thrift industry is also in trouble. It lost a record \$5.2 billion in the fourth quarter of last year and bank regulators are bracing for more than 100 bank failures in the next 12 to 24 months.

The market for auction-rate debt is the latest casualty of the subprime mortgage crisis. Sellers of auction rate debt include local governments and quasi-governmental agencies like the Port Authority of New York and New Jersey. These issuers use the auction-rate market to borrow long-term while paying short-term interest rates. Investors accept lower interest rates on this debt because it is auctioned off with enough frequency to allow them to sell at will. Recently, some market rate auctions failed for lack of willing buyers, sending interest rates soaring and hurting municipal borrowers.

The Federal Reserve appears ready to use all of the tools at its disposal to avoid a deeper credit crisis. It is lowering interest rates and at the same time buying up mortgage-backed debt of questionable value from lenders in exchange for solid

treasury bonds. The goal is to ease some of the current credit tightness. However, the Fed's major policy tools – lower interest rates and easier money – are ill suited to today's credit market problems, which are caused by a lack of confidence in credit quality. Moreover, by continuing to lower interest rates, the Fed risks significantly higher future inflation.

Inflation is already a problem. Wholesale prices have been rising at the fastest pace in more than 26 years and consumer prices are rising at the fastest rate in almost 16 years. Crude oil prices have surpassed their previous record set in April 1980. The April 1980 price, \$39.50 a barrel, is equivalent to \$103.76 today. Higher oil prices are partly a reflection of the dollar's decline vis-à-vis foreign currencies.

It takes between 12 and 18 months for lower interest rates to fully affect the real economy. Lower interest rates coupled with the newly enacted fiscal stimulus package will both impact the real economy later this year. The resulting inflationary spiral could force the Fed to reverse course and begin raising interest rates by

Historical Rates of Job Change on Long Island

Year	Average Annual Jobs	Net Change
2000	1,221,900	28,400
2001	1,222,900	1,000
2002	1,220,100	-2,800
2003	1,227,300	7,200
2004	1,238,700	11,400
2005	1,244,500	5,800
2006	1,252,500	8,000
2007	1,268,100	15,600

Source: New York State Labor Department

early next year.

Higher food and energy prices and falling home prices are causing consumers to retrench. Retail sales declined by 0.6 percent in February. This followed an increase of 0.4 percent in January and a decline of 0.7 percent in December. Consumer spending is currently the weakest it's been since late 2001 during the last recession. Consumer confidence has been diminishing since July. Households have an estimated \$915 billion in credit card debt and many cardholders are increasing their card balances or taking cash advances on their cards. These behaviors typically portend an increase in credit card defaults. Unlike mortgage debt, credit card debt is unsecured so that a default means a total loss to the lender. Consumer spending, which accounts for 70 percent of economic activity in this country, was responsible for more than 90 percent of last year's 2.2 percent increase in GDP. Therefore, a significant consumer pullback could prolong the recession.

Until now, strength in commercial construction has offset the weakness in residential construction. However, tight credit market conditions have also put commercial construction on hold. Sales of commercial

property have weakened and commercial values are declining in some areas. Loose lending standards were also rife in the commercial property market. By early 2007, some loans were made for up to 120 percent of a property's value. And, like residential loans, commercial loans were sliced and diced, subdivided into tranches according to risk, and sold to investors. An estimated \$730 billion in outstanding securities are backed by commercial mortgages. The downturn in the commercial property market is not expected to be as severe as the residential downturn because of the lack of overbuilding in most areas. And, because commercial properties produce income, commercial property owners can generally remain current on their mortgage payments.

Business fixed investment is also likely to decline. Employers cut payrolls sharply during the last recession and were slow to hire workers or buy equipment when the economy recovered. This led to a string of record

profits. Today, profit growth is slowing because of rising commodity prices and a lack of pricing power in many industries. Domestic companies are suffering most. In the past year, earnings from abroad accounted for almost all of the profit growth of U.S. companies; domestic earnings grew by only 0.9 percent.

The U.S. Economic Outlook. There have been 10 recessions since World War II, approximately one every six years. Their average duration was about 10 months. The most severe post-war recessions occurred in 1973-75 and 1981-82. The business-cycle dating committee of the National Bureau of Economic Research designates when recessions begin and end. Recessions are defined as a downturn in GDP for two consecutive calendar quarters. The National Bureau defines a recession as a significant, protracted and broadly based decline in economic activity affecting income, employment, retail sales and industrial production.

It has become clear that falling home prices and credit market tightness could persist for some time. The falling dollar is also likely to stoke inflation. The dollar has fallen by more than 40 percent against the euro and by more than 20 percent against a broad basket of foreign currencies in

Trends in the Median Price of Newly Sold Nassau-Suffolk Homes

Month	Nassau	% Change From Prior Year	Suffolk	% Change From Prior Year
2007				
July	\$495,000	1.0	\$405,000	-1.2
August	502,500	1.5	409,900	-1.2
September	475,000	-4.0	388,000	-6.5
October	474,000	0.4	385,000	-1.3
November	461,500	-0.8	387,300	-2.0
December	447,500	-4.8	385,000	-3.4
2008				
January	440,000	-2.2	373,500	-6.0
February	458,000	-0.2	359,500	-5.2

Source: Multiple Listing Service of Long Island

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

2007	Nassau	Suffolk	Nassau-Suffolk
First Quarter	-2.3	5.2	1.5
Second Quarter	3.1	5.5	4.4
Third Quarter	0.6	1.5	1.1
Fourth Quarter	2.6	1.2	1.8
October	-3.6	-4.6	-4.1
November	3.4	3.6	3.5
December	6.8	3.9	5.2
2008			
January	1.8	0.1	0.9
February	3.4	5.6	4.6

Source: New York State Department of Taxation & Finance

the past six years. These developments could motivate consumers to begin saving more, something they have not done in almost a decade. Each one percent increase in the savings rate causes consumer spending to decline by one percent. Some analysts believe that the U.S. economy is in danger of slipping into "an adverse feedback loop." That is, tighter credit conditions would depress business investment and consumer spending, which in turn would lead to even tighter credit conditions. This means that the current recession could be longer and deeper than most recent post-war recessions.

The Long Island Economy

The Long Island economy is continuing to expand, despite worsening business conditions nationally. Long Island gained 15,600 jobs last year, its largest job gain since 2000. Growth has been concentrated in educational and health services, tourism and professional and business services. Unemployment rates have edged up slightly over the past year. However, with record numbers of baby boomers on the verge of

retirement and ongoing labor force shortages in a broad range of critical skill industries, the Long Island labor market is expected to remain tight for some time.

Home price declines on Long Island have also been relatively modest. In the twelve months ending in February, median home prices were virtually unchanged in Nassau and down by only 5.2 percent in Suffolk from their year-ago levels. However, the inventory of unsold homes has been rising. In February, there were 23,046 homes on the market in Nassau-Suffolk, an increase of 7.5 percent last February. This inventory

could increase substantially if home foreclosures worsen and foreclosed homes return to market.

Consumer spending, as indicated by trends in sales tax revenues, has also held up relatively well. Bi-county sales tax revenues increased by 3.5 percent in November and 5.2 percent in December on a year-to-year basis. Although sales tax revenues increased by less than one percent in January, they bounced back in February. February revenues were 4.6 percent above year-ago levels. Shoppers are still using their holiday gift cards to scoop up post-holiday bargains and Wall Street firms paid near record year-end bonuses, \$33.2 billion, last year. These bonuses support high-end spending on Long Island and this spending ultimately trickles down into the general economy.

Long Island's office market is also doing relatively well. Fourth quarter 2007 office vacancy rates were 8.8 percent in Nassau and 10.8 percent in Suffolk. The net absorption of office space was positive in both counties last year, indicating that more space was leased than came to market. There has been relatively little new office construction on Long Island in recent years. Moreover, Long Island has not experienced the job cuts that

The Long Island Office Market, Fourth Quarter 2007

County/Town	Square Feet of Office Space	Square Feet Vacant	Percent Vacant
Nassau County	27,859,326	2,459,762	8.8
Hempstead	11,885,469	908,209	7.6
North Hempstead	8,675,074	700,922	8.1
Oyster Bay	7,298,783	850,631	11.7
Suffolk County	17,968,008	1,945,220	10.8
Babylon	538,500	28,483	5.3
Brookhaven	1,714,122	220,023	12.8
Huntington	9,220,014	964,310	10.5
Islip	4,832,949	576,217	11.9
Riverhead	673,400	78,894	11.7
Smithtown	989,023	77,293	7.8

Source: Grubb & Ellis

would prompt employers to return significant amounts of unneeded office space to market.

Planning for Long Island's Future

With the nation's economy deteriorating rapidly, Long Island may be facing a period of relatively slow economic growth, if not actual recession. This may be the time for Long Island to inventory its competitive strengths and weaknesses and implement policies to ensure future economic competitiveness.

Building affordable housing so as to retain more young workers and keep seniors here is clearly a priority. This could be accomplished in part by building "transit friendly" mixed-use villages around transportation facilities in some of Long Island's older downtowns. Reverse commuters from New York City are needed to staff Long Island's businesses, particularly

as baby boomers retire in growing numbers. Reverse commutation cannot be increased substantially without a third rail on the Long Island Railroad. The technologies emerging from Long Island's prestigious research institutions could become the basis for numerous, well-paying jobs if existing technology transfer mechanisms were buttressed.

Several Long Island communities are moving in these directions. The Towns of Babylon and Huntington currently offer fast-track development incentives and special tax subsidies to attract "eco-tech" firms to the Route 110 business corridor. Both towns are looking to redevelop the abandoned Fairchild Republic property that stretches east from Route 110 to New Highway. Redevelopment plans include affordable housing, retailing and research facilities around a reopened LIRR station. Ideally, this

new transit friendly village could house the scientists and technicians employed at the nearby Broadhollow Bioscience Park and throughout the Route 110 business corridor. The reopened LIRR station would link local scientists with Manhattan based research institutions.

The Village of Patchogue is planning a mixed-use development, to include retail and office uses, affordable housing and a brand name hotel, at the core of its downtown. Large mixed-use developments that include higher-density residential housing are also proposed for the HUB in Nassau County and the community of Yaphank in Suffolk County.

Periods of recession impose hardships on both households and businesses. However, they also provide the breathing room needed to assess the changes needed to ensure more robust future economic growth.

Job Changes on Long Island, by Industry

January 2007-08

(number of jobs)

