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THE SLOWING NATIONAL ECONOMY: IT'S LIKELY IMPACT ON LOCAL BUSINESS CONDITIONS

The U.S. economy seems caught in a tug of war between the forces of economic growth and decline. Home prices are continuing to fall, mortgage defaults are rising and lending is slowing. This scenario typically leads to recession. However, rising exports and a relatively healthy job market are keeping the economy afloat. How these forces play out will determine whether the nation slips into recession this year or simply experiences a period of slow economic growth. This article analyzes current U.S. business conditions and discusses their likely impact on the Long Island economy.

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The Nation's Economy: Moving Toward the Brink of Recession

By most standards, the U.S. economy entered the final quarter of last year in relatively good shape. Real GDP increased at a robust annual rate of 4.9 percent in the third quarter, with growth driven by exports, consumer and government spending. However, economic growth slowed dramatically in the fourth quarter of last year as credit markets seized up once again and mortgage defaults accelerated. With home prices falling, credit less available and oil prices near their inflation-adjusted peak, consumer confidence plunged to its lowest level since late 2005.

The Federal Reserve responded to the crisis by repeatedly cutting the federal funds rate, the rate at which banks borrow from each other, and the discount rate at which banks borrow from the Fed. Between August and December 2007, it reduced the federal funds rate from 5.25 percent to 4.25 percent and hinted that further rate cuts might be forthcoming. However, further easing may be contingent on the rate of inflation, which appears to be accelerating. November wholesale prices rose at their fastest rate in 34 years and November consumer prices registered their biggest monthly increase since late 2005.

By lowering borrowing costs, the Fed hoped to encourage more consumer and business spending. However, this medicine may not work as well as in past economic slowdowns because today's credit crisis reflects not only a lack of liquidity in credit markets but also a lack of confidence in the accuracy of asset prices. In the wake of the subprime mortgage meltdown, there is widespread concern about the value of asset-backed securities, notably those backed by subprime mortgages. As a result, banks and other financial institutions have become more reluctant to make loans.

Continued anxiety in credit markets is reflected in the fact that the London Interbank Offered Rate (LIBOR), to which many business loans are pegged, remains unusually high. Normally, the LIBOR closely tracks the

Table 1

Trends in Long Island Payroll Employment

Industry	Number of Jobs, Nov. 2007	Net Change, Nov. 2006-07
Manufacturing	84,400	-1,900
Construction	72,100	600
Wholesale Trade	74,200	600
Retail Trade	168,700	800
Transportation, Warehousing, Utilities	36,000	-800
Information	30,200	200
Financial Activities	77,400	-2,700
Professional & Business Services	169,700	2,800
Educational & Health Services	211,800	3,800
Leisure & Hospitality	96,200	1,600
Other Services	52,800	100
Government	203,700	0
Total Non-Farm Employment	**1,277,200**	**5,100**

Source: New York State Labor Department

U.S. federal funds rate. However, whereas three-month Treasury bill yields fell from 4.8 percent to 2.9 percent between late June and December, the three-month LIBOR rate fell from 5.36 percent to only 5.11 percent during this period. Thus, many businesses whose loans are pegged to the LIBOR are still experiencing relatively high borrowing costs. As long as the housing downturn continues to worsen, financial markets will be susceptible to more shocks and credit tightness will remain a threat to the economy.

Normally, when lenders sustain large financial losses, credit contracts, consumers and businesses retrench and a recession ensues. However, the falling U.S. dollar and strong global economic growth have increased the demand for U.S. exports. Net exports added 1.4 percentage points to U.S. economic growth in the past six months, more than offsetting the 0.7 percentage point drag to GDP caused by residential housing declines.

The U.S. job market has been another area of strength. Although job growth is slowing, the slowdown has not yet seriously impacted household incomes. Whereas average monthly job growth was 212,000 in 2005 and 189,000 in 2006, only 118,000 jobs were generated monthly during the first eleven months of 2007. November job growth, 94,000 new jobs, was respectable. However, private-sector job growth slowed to only 64,000 jobs in November as compared with growth of 169,000 private-sector jobs in the previous November. Slowing private-sector job growth is a red flag for the economy.

Another red flag is the apparent slowdown in corporate profit growth. Third-quarter 2007 corporate earnings were 4.4 percent below their year-ago levels, the first such profit decline since 2002. Domestic companies have been particularly hard hit. In the past year, earnings from abroad accounted for almost all of the profit growth of U.S. companies. Profits are likely to remain weak due to a combination of record energy prices, tighter credit market conditions and a general lack of pricing power in many industries. Moreover, the growth of worker productivity has not been sufficient to enable companies to absorb rising costs and protect their profit margins. Weaker profits are likely to discourage capital spending and could lead to slower job growth or actual layoffs. This would hurt consumer spending.

Whether the nation's economy slips into recession or escapes with only a period of slow growth will depend on how well consumer spending holds up and how deep the housing crisis becomes. Consumer spending was relatively weak during the recent holiday season. Spending from Thanksgiving to Christmas rose only 2.6 percent over the previous year according to MasterCard Advisors. This was the weakest performance in at least four years. By comparison sales grew 6.6 percent in 2006 and 8.7 percent in 2005. However, online spending rose by 22.4 percent, helping to offset weak sales at brick and mortar stores. Consumer spending has exceeded income growth for many years. With the household savings rate hovering just above zero, consumers have little to fall back upon in the event of layoffs. Rising delinquency rates on credit cards suggest that consumers are stretched thin and that a consumer pullback may occur after the holiday shopping season.

The other big imponderable is the potential depth of the housing crisis. Sales of new homes fell 42 percent and sales of existing homes have dropped 30 percent in the past two years. New home starts are 47 percent below their January 2006 peak. Builders have put construction plans on hold and are offering generous incentives to reduce the current overhang of unsold homes. The subprime mortgage crisis is also likely to worsen before it improves. Interest rates are scheduled to reset this year on an estimated $362 billion in adjustable rate subprime mortgages. An additional $152 billion in other adjustable rate debt will also reset this year.

The Mortgage Bankers Association estimates that 1.35 million homes entered the foreclosure process in 2007 and that another 1.44 million homes will do so this year. Foreclosed homes typically sell at a discount of 20 to 25 percent, putting downward pressure on home prices. The Joint Economic Committee of Congress estimates that lost real estate wealth

Table 2

The Long Island Office Market, Third Quarter 2007

Office Market, By Town	Total Office Space (Sq. Ft.)	Vacant Office Space (Sq. Ft.)	Percent Vacant
Nassau County	**27,852,369**	**2,493,642**	**9.0**
Hempstead	11,885,469	983,284	8.3
North Hempstead	8,668,817	671,089	7.7
Oyster Bay	7,298,083	839,269	11.5
Suffolk County	**17,848,008**	**1,865,260**	**10.5**
Babylon	538,500	38,888	7.2
Brookhaven	1,714,122	212,993	12.4
Huntington	9,100,014	849,725	9.3
Islip	4,832,949	609,608	12.6
Riverhead	673,400	78,894	11.7
Smithtown	989,023	75,152	7.6

Source: Grubb & Ellis Company

from foreclosures on subprime loans will total $71 billion and that another $32 billion will be lost as foreclosed homes drive down the price of other homes in the neighborhood. Although the Federal government has announced a mortgage relief plan, it will not help homeowners who are currently in foreclosure.

It is estimated that every $1 decline in home prices reduces consumer spending by 9 cents. According to the Federal Reserve, the current value of residential housing is $21 trillion. Therefore, if home prices fall by at least 10 percent, as expected, there would be a loss of $200 billion in consumer spending. A 15 percent home price decline would cause consumer spending to decline by $300 billion.

The nation has moved closer to recession in the past several months. The housing slump alone is unlikely to lead to recession because home construction accounts for less than 5 percent of the nation's GDP. However, if lenders continue to curb lending because of mortgage-related write offs and if consumers cut their spending as expected, a recession this year is a real possibility. Recessions lead to the repricing of inflated assets such as residential housing. Another recession would force households to cope with years of accumulated debt and lenders to deal with the bad loans stemming from the recent housing boom. This could depress consumer and business spending for some time, which would defer any recovery from recession. Given these circumstances, any potential recession could be deeper and longer than the average post-World War II downturn.

The Long Island Economy

A potential U.S. recession could have serious repercussions for the Long Island economy. A prolonged credit squeeze would be particularly harmful to the local business community, which is dominated by small businesses. Small businesses are among the first to be shut out of credit markets when a credit squeeze occurs.

The Employment Situation. Long Island gained 5,100 payroll jobs between November 2006 and November 2007, all of them in the private sector. Significant employment declines in manufacturing and financial activities were offset by gains in professional and business services, educational and health services and tourism. Long Island is continuing to enjoy a full employment economy despite relatively modest job growth. Its November unemployment rate was 3.7 percent, up only slightly from a rate of 3.3 percent in November 2006. (See Table 1).

Residential Housing. Many recent Long Island homebuyers utilized subprime mortgage instruments that will reset to higher interest rates this year and next. Presumably this will lead to more mortgage defaults and foreclosures and further declines in home prices. To date, home prices on Long Island have not fallen significantly. According to the Multiple Listing Service of Long Island, the median price of newly sold homes declined by 0.8 percent in Nassau and by 2.0 percent in Suffolk in the twelve months ending in November. However, price declines have been greater in higher-end housing markets where sellers have more leeway to lower their selling prices. Long Island's inventory of unsold homes has also been increasing. There were 9,856 unsold homes in Nassau in November, a 4.2 percent increase over the prior November. The number of unsold homes in Suffolk, 14,373, was 8.0 percent higher than a year earlier. As more initial "teaser" interest rates associated with subprime mortgages begin to reset, the inventory of unsold homes on Long Island is likely to increase further.

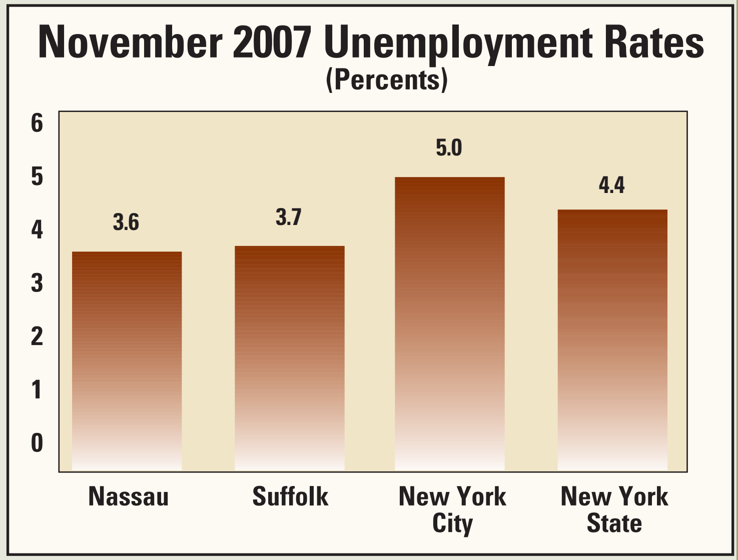
The Office Market. The weakness in residential housing has been offset to some extent by strength in commercial real estate. Long Island's third quarter office vacancy rate was 9.0 percent in Nassau and 10.5 percent in Suffolk according to Grubb & Ellis. (See Table 2) Moreover, the net absorption of office space has been positive in both counties, indicating that more space was leased than came to market. In the first three quarters of last year, there was positive net absorption of 161,795 square feet in Nassau and 506,623 square feet in Suffolk. Long Island's

Table 3

Percent Change in Nassau-Suffolk Sales Tax Revenues, 2006-07

Month	Nassau County	Suffolk County	Bi-County
2006			
September	6.3	-5.5	-0.5
October	6.7	7.9	7.3
November	2.7	3.1	2.9
December	8.7	3.7	5.9
2007			
September	-2.7	-2.2	-2.4
October	-3.6	-4.6	-4.1
November	3.4	3.6	3.5

Source: New York State Department of Taxation & Finance



Class A office rents are highly price competitive with those in midtown and downtown Manhattan. In the third quarter of last year, Class A office rents averaged $35.38 per square foot in Nassau and $27.95 per square foot in Suffolk as compared with $93.46 per square foot in midtown Manhattan and $60.60 per square foot in downtown Manhattan. Given these disparities, Long Island is likely to benefit from the influx of firms leaving Manhattan in search of more moderately priced office space.

Consumer Spending. Consumer spending on Long Island, which had been weak throughout the fall, picked up in November. Sales tax revenues, a barometer of consumer spending, increased by 3.4 percent in Nassau and 3.6 percent in Suffolk between November 2006 and November 2007. This exceeded the comparable gain during the previous twelve months, which suggests that Long Island retailers enjoyed a moderately successful holiday selling season. (See Table 3). However, consumer spending could fall off significantly in the first quarter of this year. Household incomes are being eroded by higher inflation. The November consumer inflation rate in the New York Metropolitan Region, which includes Long Island, was 3.9 percent. This was the highest rate of inflation since August 2006, when consumer prices rose by 4.7 percent. Higher food and energy prices, falling home prices, tighter credit markets and a high level of accumulated debt are likely to take a toll on consumer spending in the next several months.

Long Island's Economic Outlook

How deep the housing slump becomes will determine whether the Long Island economy slips into recession or remains in positive territory. Declining home prices create a negative wealth effect. Unless this is offset by higher wages or rising stock prices, consumers will spend less. The negative wealth effect, the bite that higher food and energy prices are taking out of discretionary incomes and the rising cost of consumer borrowing are all but certain to put a dent in Long Island consumer spending this year. Moreover, the high-end consumer spending that depends on year-end Wall Street bonuses may be muted this year because these bonuses are expected to be generally lower than last year.

It remains to be seen whether a combination of slower consumer spending, declining home prices and tighter credit markets will be enough to cause employment layoffs and tip the Long Island economy into recession. However, the danger of a recession on Long Island is greater today than it has been at any time in the last several years.