The Connecticut Economic Outlook: November 2007

Troubling Times:

Credit Crisis, Federal Reserve Policy: What Future for Connecticut?

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This outlook first sets the background of the impacts of the crisis resulting from subprime mortgages, lower Federal Reserve rates, the falling dollar, and environmental initiatives. This unusual context challenges our ability to forecast our economic path and to make reasonable interpretations of our forecast.

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Overview: Modest Growth in Output but Few New Jobs

Recent economic news has been dramatic and even frightening: tens of thousands homeowners losing their homes to foreclosure; credit markets cratering; the Federal Reserve, applying an economic tunicate, cutting interest rates twice. But the cuts compound fears about the stability of the dollar in international trade and the greenback begins losing value rapidly against other major currencies. Tensions with Iran, political instability in Pakistan, and continued global growth in demand for energy drives petroleum prices towards $100 a barrel. Within months these volatile developments may unleash sufficient inflation in the United States to force the Federal Reserve to reverse course and raise rates. We have threatening, dark thunder clouds—but we don't know whether they will unleash a gentle rain or a flood.

Despite all the dire news, the economy has actually been performing reasonably well. Nationally, growth has continued at more than 3%; Connecticut's economy has followed suit. The current forecast sees continued though slowing growth, both nationally and in the state. Following the pattern of recent years, even as Connecticut's economy continues to expand, this Outlook sees weak job growth, possibly tailing off by the middle of 2009, and then experiencing some job loses.

The challenge in constructing this Outlook is to balance the traditional data-driven analysis with the fast-breaking economic developments flowing from the subprime crisis, the swift Federal Reserve intervention, and the threat—and opportunity—of the falling dollar. So far, the damage has been significant, but largely limited to the residential housing market. As long as the global economy remains healthy—it is now boosting American performance—and American policy manages to steer the economy clear of the threatening shoals of inflation and a credit crunch, we may yet achieve a "soft landing," unwinding the serious imbalances built up over the last five years without broad or deep economic injury. But clearly that task is now more difficult than anyone thought it would be a year ago, or even three months ago.

Background

We must exercise caution in interpreting this outlook for the Connecticut economy. Major developments in credit markets, Federal Reserve policy, and the value of the dollar—recently falling rapidly against most major currencies—have not yet worked their way fully through the economy. Yet they are factors that will be critical to the performance of the Connecticut economy over the next two years. But we are not yet able to incorporate their influence into the forecasting process, raising special challenges to building and interpreting this Connecticut Economic Outlook. The Congressional Joint Economic Committee (JEC) analysis on the subprime crisis anticipates that Connecticut will suffer foreclosures inflicting loses of $1.4 billion, $876 million directly, another $531 million through declining prices of properties in neighborhoods where foreclosures occur. With falling property values, local property tax revenues will suffer a loss of $19 million. Combined with New York and New Jersey, the JEC expects the tri-state area to bear 16.6% of the $103 billion cost of the mortgage crisis; and this does not include the erosion in property tax revenues. Beyond that, the Committee's estimates are clearly conservative: they do not consider the injury that will result from the sharply reduced availability of mortgages for all potential home buyers, the broader injury to credit markets in general, or even the potential foreclosures on mortgages written after Q3 2007.

Because the JEC developed its projections before the Federal Reserve's dramatic half point cut in interest rates—a cut recently re-enforced with another quarter point reduction--their analysis may see the situation in starker terms than will be the case. But the JEC limited its estimates of community impacts to the immediate neighborhood of expected foreclosures rather than the influence—for good or bad—of lower interest rates that have broader significance. As expectations of the Federal Reserve's action spread, the dollar began to lose significant value in international trade. Since the beginning of August, it has fallen nearly 12% relative to the Canadian dollar, 6% relative to the EURO, more than 6% relative to the Yen, and 3% relative to the British pound. And it continues to fluctuate daily, but continues in general to depreciate. Except where long-term contracts are fixed in US dollars and American consumers are willing to absorb price increases, importers will be hurt and consumers will switch to American-source goods. With U.S. imports at 17.0% of GDP, the devaluation will put upward pressures on prices--oil and gas in particular—and add to US inflationary expectations. As a result, the Federal Reserve has already signaled it may not make further rate cuts—and inflationary pressures that their cuts will generate may force the Fed to reverse course within months.

But there is also good news in a weak dollar. U.S. manufacturers have the opportunity to reclaim domestic markets and expand exports. Foreign tourists—if willing to surmount the more stringent barriers we have erected at our borders—now find America an inexpensive place to visit and shop. Higher fuel prices encourage car pooling, increasing telecommuting, using mass transit, and/or moving closer to places of work. Such changes in commuting patterns may generate some welcome reductions in energy use and global-warming carbon emissions.

At annual rates, U.S. Real Gross Domestic Product (RGDP) in 2007-Q3 grew at 3.9%. Given the above issues, national chain linked RGDP growth is expected to drop off to 3.1% and 2.0% in each of the next two years. Despite all of the drama in economic news in the last several months, Connecticut has enjoyed sustained output growth in the most recent two quarters of 3.8% and 3.9% at annual rates, mirroring national growth. And this Outlook anticipates continued growth of 2.0% for 2008 and 1.8% for 2009. But there is a rather impressive fly in the soup: will the national economy actually perform so well—and Connecticut's along with it? Given the turmoil arising out of the subprime mortgage market issues are of particular interest.

What Connecticut Faces in the Residential Market: A Regional Perspective

For Connecticut and the tri-state area, two developments seem to emerge from the latest detailed data on housing permits. First, residential construction permits for Connecticut and New York (Table 1) suggest that by the end of 2007 contractors will have adjusted to expectations concerning foreclosures. And there are suggestions that population is beginning to relocate in order to minimize transportation costs.

Table 1:
Private Residential Permits Percentage Change: Tri-State Area Q1–Q3

State/Years	All Units	Single Units	Structures with Five or More Units		
			Units	Structures	Average Size (Units)
CT					
2005-2006	-15.3	-18.0	-9.0	-17.9	12.3
2006-2007	-18.6	-24.4	5.6	-20.9	26.1
2005-2007	-31.0	-38.0	-3.9	-35.1	41.6
NY					
2005-2006	-5.8	-13.0	-4.5	-16.3	15.4
2006-2007	-1.9	-15.2	20.6	4.3	14.6
2005-2007	-7.5	-26.2	15.3	-12.8	32.3
NJ					
2005-2006	-14.1	-13.3	-21.1	0.4	-21.8
2006-2007	-24.5	-26.0	-16.0	-4.0	-11.9
2005-2007	-35.1	-35.8	-33.7	-3.6	-31.1

Source: Bureau of the Census

Residential construction seems to be adjusting rapidly to the new environment. Expectations for permits over the next nine quarters are down, compared the previous nine quarters before the slide began, by nearly 13,500, just short of the 14,079 sub-prime foreclosures the JEC expects over the next nine quarters.[1] Thus the drop-off in housing permits has already gone a long way to adjust to foreclosed homes coming back onto the market. Connecticut and New Jersey are each seeing a similar decline in total permits; New York is seeing a smaller decline. Permits for single housing units in all three states have experienced substantial and accelerating declines over the last two years. While the number of permits for structures with five or more units has followed a similar pattern in Connecticut, the number of units has not dropped as much, due to fillings for projects with more units, particularly in 2007. Permits

[1] Compared to the nine quarters prior to 2005Q4, expectations 2007Q3 to 2009Q4 are for 13,375 fewer permits.

for structures with five or more units in New York were up sufficiently in 2007, resulting in a 15.3% increase in units over the two years. As in Connecticut, part of New York's increase in multiple units was also partially attributable to the increasing number of units per structure. Permits for structures with five or more units in New Jersey fell less than in the other two states, but the average number of units per structure also dropped so that the percentage change in the total number of units permitted was similar to the declines overall in that state. The shift in Connecticut and especially New York to an increasing share of units in urban areas suggests that people may be reducing transportation costs by moving closer to work and/or mass transit.

Permit values reveal the direction of future construction activity. Table 2 presents the percentage changes in the value of private residential construction permits, paralleling much of what Table 1 covered. Two points are clear at a glance: declines in aggregate value of all units and single family homes are considerably smaller than for numbers of units, and the value of permits for structures with five or more units is positive in both Connecticut and New York (though a single project boosted values in Connecticut for 2006-2007, so one should avoid reading too much into it). As it is aggregate value, not units, that drives activity, construction should not suffer as much as mere permit data suggests.

Table 2:
Value of Private Residential Permits Percentage Change: Tri-State Area Q1 –Q3

State/Years	All Units	Single Units	Five or more Units
CT			
2005-2006	-9.9	-11.8	12.9
2006-2007	-9.9	-16.9	75.6
2005-2007	-18.8	-26.7	98.3
NY			
2005-2006	-0.4	-9.5	11.6
2006-2007	-4.3	-11.5	30.0
2005-2007	-4.7	-19.9	45.1
NJ			
2005-2006	-0.3	-8.6	-10.1
2006-2007	-19.3	-18.1	-15.5
2005-2007	-19.6	-25.1	-24.0

Source: Bureau of the Census

How Will Connecticut Fare?

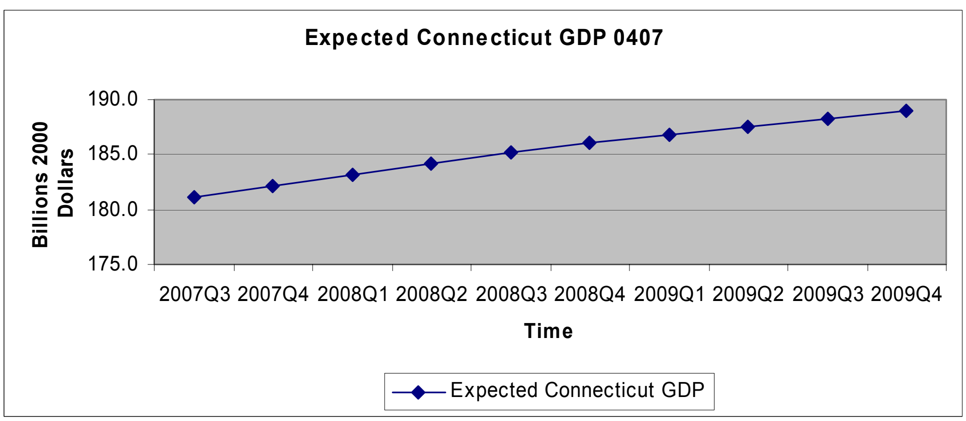
Given JEC expectations that it will take much of next nine quarters for the sub-prime mortgage debacle and associated housing surpluses to work their way through the economy, Connecticut's seasonally adjusted unit housing permits have already made most of the needed adjustments. The Outlook anticipates they will decline gently from 1,911 in the next quarter to 1,891 in 2009Q4. But there is much uncertainty in this view that the worst is over for the housing industry, with only a 2.5% decline in 2008 followed by a half a percent reduction in 2009. The sub-prime crisis could spread, forcing the Federal Reserve to consider further cuts to stave off a serious recession--or the collapsing dollar may spark sufficient inflation to force the Fed to raise rates, putting more downside pressure on economic activity.

Despite the ubiquity of subprime impacts, Connecticut enjoyed sustained growth in the most recent two quarters of 3.8% and 3.9% in its real GDP at annual rates, following national growth and along the lines previous Outlooks forecast. This Outlook continues to anticipate continuing real though slowing growth of 2.0% for 2008 and 1.8% for 2009.

Consistent with the devalued dollar affording wider opportunities for American exports, in Connecticut real manufacturing earnings in 2007-Q3 outperformed expectations by $7.13 a week. Nevertheless, real manufacturing earnings will continue to be under pressure from competing imported goods and services and the rising cost of imported inputs such as energy, potentially leading to annual declines by less than half a percent.[2] Depending on the length and depth of the dollar devaluation, foreign competition will weaken, and efficient manufacturers will have additional room to expand their exports on the back of the devaluated greenback.

The above factors should support modest growth for Connecticut GDP and seasonally adjusted employment. This Outlook's anticipates Connecticut GDP growth in output slightly above the lower bound from the pervious Outlook, with 2% growth in 2007 and 1.8% in 2009. Chart 1 presents Connecticut quarterly GDP.

Chart 1

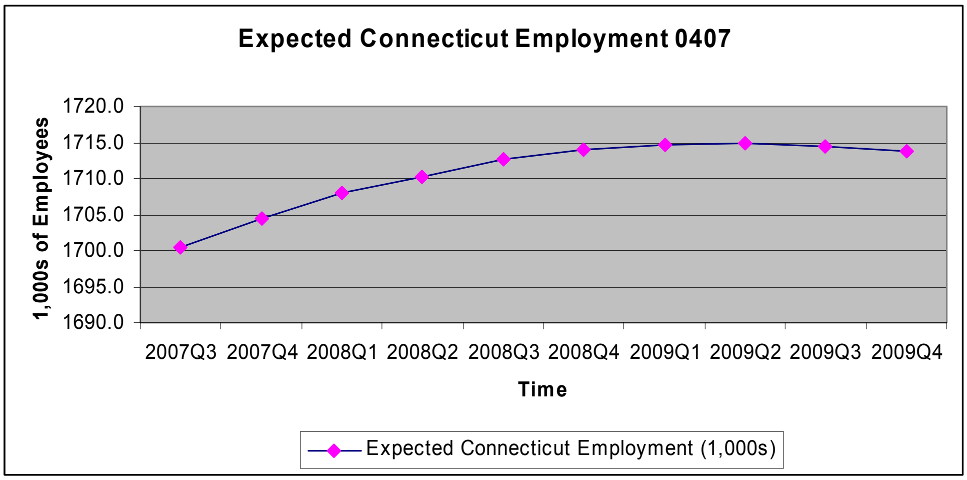


The previous Outlook suggested that seasonally adjusted employment for 2007-Q3 would exceed 1,700,000. Preliminary data suggest Connecticut passed that benchmark--narrowly, by only 488 employees. The previous Outlook anticipated that seasonally adjusted

[2]China pegs its currency primarily to the dollar, so the current devaluation delivers little direct benefit in competition with China. However, China is also a major importer of components that are then assembled there; Chinese producers must necessarily pass through that part of their cost driven by the rising cost of imported components. There may thus be modest gains even on this front.

employment for 2007-Q3 would exceed 1,701,000—which Connecticut did not achieve—so that this Outlook starts off with slightly lower levels of employment than expected. With continuing productivity growth, the slowdown in output growth generates small gains in employment. This Outlook sees employment growing 0.75% in 2008 and an almost vanishingly small 0.18% in early 2009—but then suffering a decline going into the fourth quarter of 2009. Chart 2 shows the levels this Outlook anticipates for employment. If real growth holds up better than now anticipated, employment growth could continue through 2009.

Chart 2



The Outlook for Separate Sectors

The previous Outlook captured dramatic changes reflecting Connecticut's surge in personal income in the first quarter of 2007—a stunning $6.1 billion increase ($4.0 billion in constant 2000 dollars, removing the influence of inflation). Connecticut's growth in Q1 outpaced national growth in personal income mostly due to bonuses in FIRE. While those data have not been revised, a decline in real personal income in Q2 of $966 million offset that rapid growth in Q1. This Outlook now supplants that decline with projected real income growth of $2.3 billion in Q3[3]. Because of the strong presence of financial intermediaries in Connecticut, the continuing turmoil in financial markets flowing from the subprime crisis will likely continue to add volatility to this Connecticut indicator, making any forecast more problematic. With three quarters of data in preliminary form, the Outlook expects Connecticut GDP growth for 2007 in Finance Insurance and Real Estate (FIRE) industry to be 3.8%. With ongoing pressures from credit markets, the Outlook cuts the rate of growth in FIRE to 3.0% and 1.9% annually going out to 2009.

[3] This projected growth in real personal income is below the growth of real average wages in manufacturing for Connecticut in Q3 but $861 million dollars higher then would have been anticipated using preliminary national rates of growth for personal income.

Manufacturing is performing well with expected growth of 4.9% in 2007. With dollar depreciation, manufacturing is likely to continue to do well, with expected growth of 3.9% and 3.0% in 2008 and 2009. The 2007, manufacturing growth will be concentrated in durable goods rather than the smaller non-durables goods manufacturers sector which continues to shrink. Both segments however will benefit from devaluation. Growth possibilities are available to those Connecticut manufacturers positioning themselves to take advantage of export and import replacement opportunities and critical trends in innovative areas, including energy initiatives – e.g., parts for Plug–in-Hybrid-Electric-Cars (PHECs), diesel engines and parts, solar and wind energy generation, biotechnologies for chemicals, fuel cells, and bio-energy.

This Outlook sees services other than FIRE continuing to grow at modest rates. Thus, the forecast sees current growth of 1.5% in 2007 declining to 1.4% in 2008 and then 1.1% in 2009. Loses in expected property tax revenues stemming from foreclosures and loses in land appreciation will curtail government growth so government's contribution to growth in Connecticut's economy will be less than half of the 5.9% experienced in 2007, falling to 2.3% in 2008, 2.0% in 2009. .

Conclusions

CCEA builds its quarterly Outlooks from empirical data that describe the recent and current levels of economic activity. Unlike earlier outlooks, this Outlook draws heavily on the JEC report on impacts of the subprime meltdown, the quick reaction by the Federal Reserve to cut interest rates, and the significant devaluation and volatility of the dollar in international exchange; these factors are all outside the normal modeling processes. Acknowledging the importance of these factors gives this Outlook better balance, and emphasizes the potential range of serious risks and upside potential that the economy faces in the next ten quarters. The danger of either credit markets freezing up still more is not negligible, nor is the possibility of a collapse in the dollar if investors flee dollar-denominated assets. But this unwinding of serious imbalances in the global economy—building for more than five years—may also deliver welcome opportunities for growth. If Connecticut businesses—resident in the birthplace of Yankee ingenuity—have the acumen to seize innovative domestic and export opportunities this environment is creating, the state and the nation may come through this period with increased strength and prosperity. It may also accelerate the much-needed movement away from our excessive reliance on oil (largely imported) and drive the effort to curtail green house gas emissions. There is almost always a silver lining to dark clouds, even economic ones.