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The national economic outlook has deteriorated significantly over the past quarter. Many analysts are placing a high probability on the occurrence of recession in 2008 as a result of the dissipation of the housing bubble, problems in the sub-prime mortgage market and the ensuing credit crunch. National labor markets have begun to deteriorate as the national unemployment rate reached the 5% level in December for the first time since November 2005. Oil prices have hovered around $100 a barrel and inflation has accelerated consistently since August and is presently running at 4.1%. The Federal Reserve has attempted to allay the fears of the market by pumping liquidity into the marketplace and reducing interest rates. How much more they can loosen monetary policy without placing upward pressure on inflation presents a conundrum for the Fed. Since the local economy has had a history of leading the nation into recession, staying in recession longer and recovering less fully, these national developments are extremely worrisome for local residents.

The National Economic Outlook

Final estimates of 2007:Q3 real GDP shows the national economy growing at a 4.9% rate after growing by 3.8% during the second quarter of 2007 www.bea.gov. Real GDP growth rates since 2002 are shown in Figure 1 below. Factors responsible for the acceleration of growth during the third quarter included increases in exports and personal consumption expenditures. If one focused only on the real GDP growth numbers, the economy would appear to be relatively healthy. A more careful analysis prevents such a conclusion however. Expenditures on new residential housing units declined by 20.5% during 2007:Q3. This was the sixth consecutive quarter of double digit declines for this component of GDP and illustrates one facet of the many problems in the housing market.

Several troublesome developments have led an increasing number of analysts to predict a recession in 2008. Among these developments are: the credit crunch brought about by the sub-prime mortgage crisis, accelerating crude oil prices, and accelerating inflation. One could argue that the economy is facing the perfect storm in terms of a slowdown in economic activity accompanied by an accelerating inflation rate. This makes monetary policy very tricky for the Federal Reserve which is attempting to achieve economic growth and ensure stable financial markets, while maintaining

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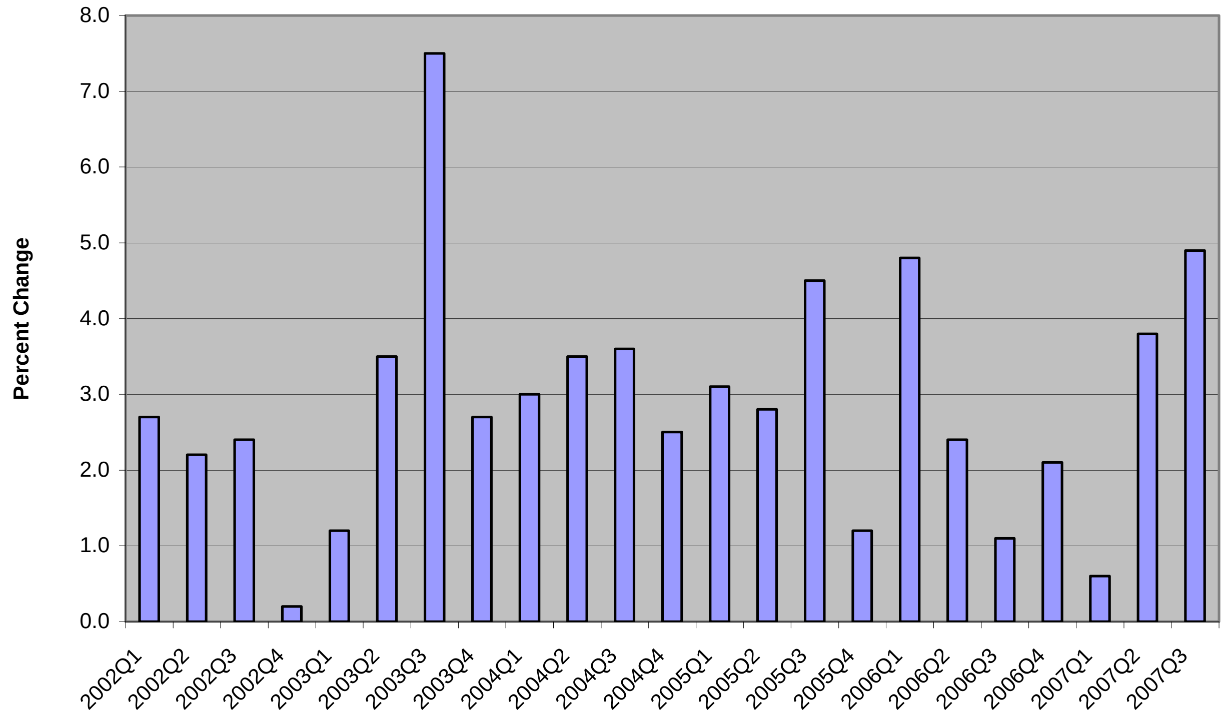
Figure 1. Real GDP Growth Rates (2002:Q1 - 2007:Q3)

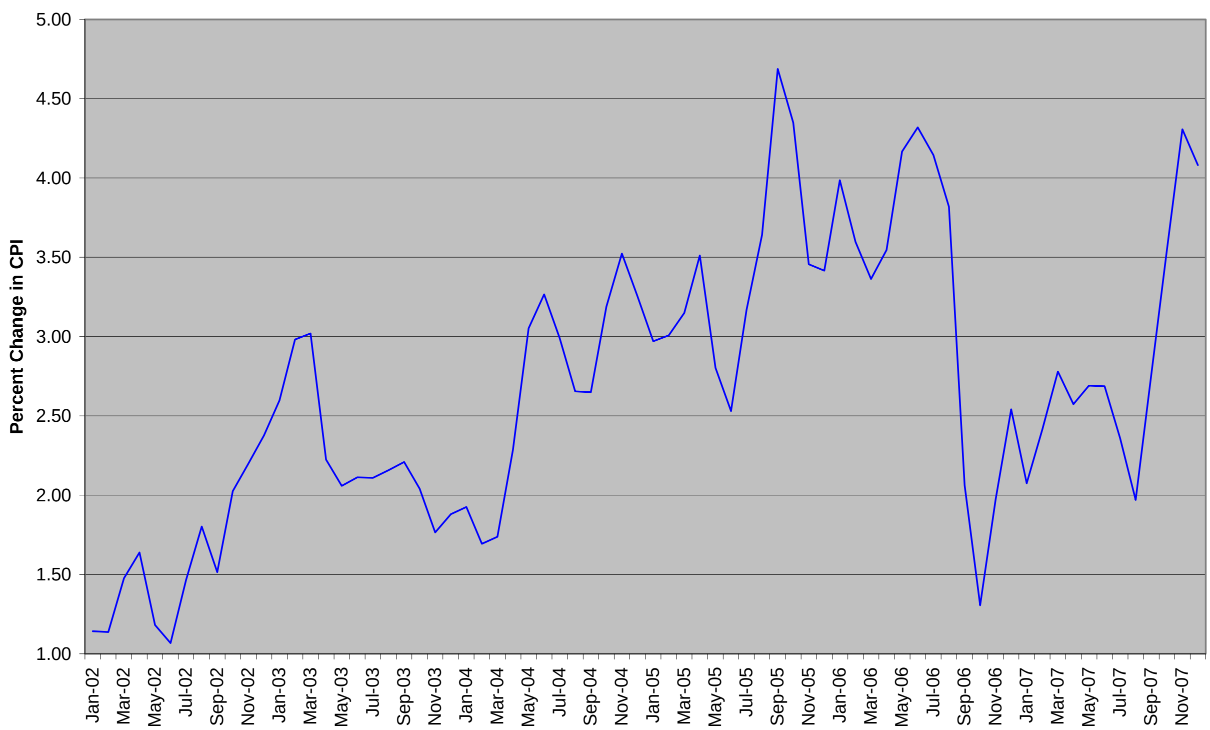


reasonable control over the rate of inflation. The Fed and other central banks from around the world have responded vigorously to the credit crunch by pumping massive amounts of liquidity into the financial system. The Fed has lowered it federal funds rate target at each of its past three meetings. At 4.25%, its target now stands 100 basis points below where it was in October 2007. To address the liquidity crisis, the Fed initiated what is known as a term auction facility in December to supplement discount window borrowing by banks. This was done to alleviate the negative stigma that banks have traditionally felt when borrowing at the discount window.

In a speech on January 10, 2008, Fed chairman Bernanke opened the door to further rate cuts by highlighting the downside risks to the economy as a result of problems in financial markets. He stated that “the outlook for real activity in 2008 has worsened, and the downside risks to growth have become more pronounced.” Bernanke also stated that additional policy easing may be necessary and has endorsed a fiscal policy stimulus. This is a clear signal that further rate cuts will occur at the January FOMC meeting. The Fed is clearly concerned about the health of the economy and has taken dramatic action to prevent an economic downturn. The trillion dollar question is, “have they responded soon enough?” Empirical analysis has shown that monetary policy changes have historically influenced the economy with a lag of from nine months to one year.

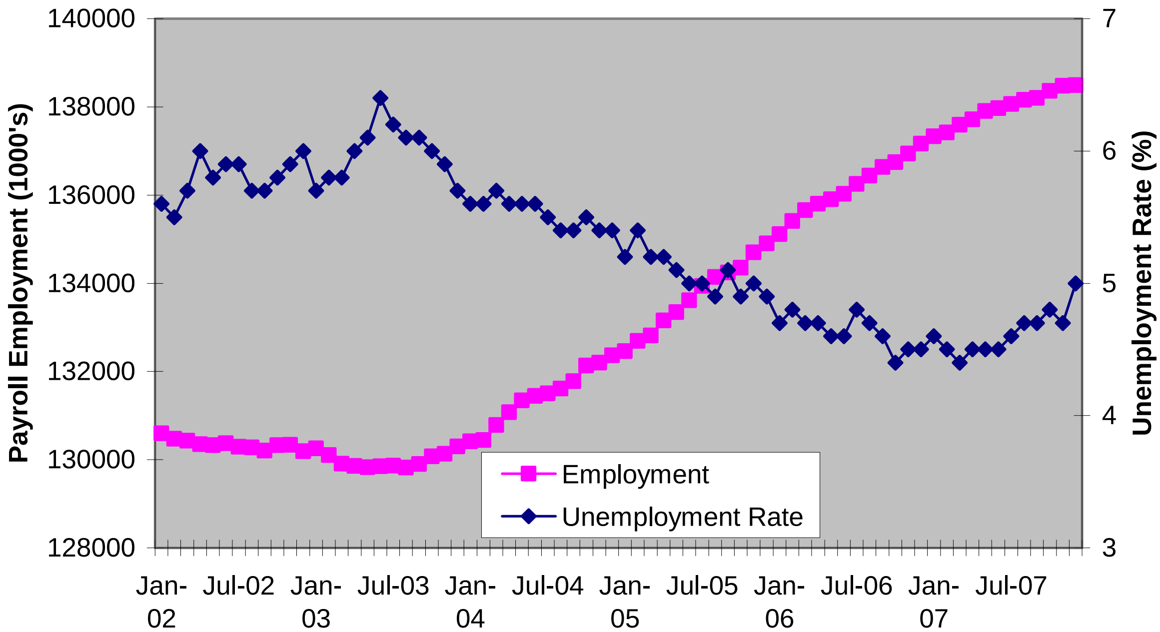
News from the inflation front has also been troublesome of late. Inflation rates based on the consumer price index www.bls.gov have trended upward from their October 2006 low. The inflation rate from December 2006 to December 2007 stood at 4.1%, somewhat above the Fed's comfort zone. CPI inflation rates since 2002 are shown in Figure 2. How much more the Fed can lower short term interest rates without placing additional upward pressure on inflation remains to be seen.

Figure 2. CPI Inflation Rates (Twelve Month Percent Change)



The December payroll employment statistics showed only an 18,000 job increase and disappointed labor market observers who expected a much bigger increase. In addition, the national unemployment rate increased to 5% in December. The unemployment rate has trended upward since March 2007. The national payroll employment figures and unemployment rate are shown in Figure 3.

Figure 3. US Payroll Employment and the Unemployment Rate



The Economic Outlook for the Upstate Region

The National Bureau of Economic Research (NBER) defines a recession as a marked period of contraction in many sectors of the economy. A more common view of recession is when real income declines for two consecutive quarters. NBER looks at changes in total output, income, employment and trade lasting for a period of time between six months and a year. Translating this concept to a regional level poses some problems, since regional product is difficult to measure in small open economies. The smaller is the region, the greater is the degree of difficulty. Additionally, the issues associated with identifying the exact timing of expansions is significantly compounded when the discussion involves different regions which may begin their cycles at different times and have them be of different durations.

For economic business cycles in the U.S., NBER has identified peak and trough months for over 50 years. The last official reference date for the national economy is the trough month of November 2001. By comparison, using employment as the basis for identifying the turning points of the local business cycle, the last trough in the Buffalo MSA was January 2006, more than four years after the national bottom. This is the case even though the peak employment month for the Buffalo region was November

2000, four months earlier than the national peak. Thus the Buffalo region's decline started before the nation's and lasted nearly four years longer. Clearly, there is no rigid connection between national and our regional cyclic activity.

The data presented in Table 1 shows the changes in employment for the major metropolitan areas of upstate New York that have accompanied recent national economic recessions. In each case, the change is measured for the period that corresponds to the employment peak and the employment trough. While these landmarks are generally cited in months and years, we have only included the average values for the 1969-1971 through the 1990-93 periods. The impact of national recessions on the individual regions varies among the regions and over time.

For the 2001 recession (last column of Table 1), the period is defined by Buffalo's peak and trough employment months, November 2000 and January 2006. During the last recession, each of the upstate regions had greater declines in employment over the business cycle than the national average, possibly reflecting the long-term movement of employment out of New York State.

TABLE 1

REGIONAL EMPLOYMENT CHANGES OVER THE BUFFALO BUSINESS CYCLE

Metropolitan Area	Employment change peak to trough 1969 - 71	Employment change peak to trough 1973 - 75	Employment change peak to trough 1979 - 83	Employment change peak to trough 1990 - 93	Employment change peak to trough 2000 - 2006
Albany-Schenectady-Troy, NY	4.09%	-1.51%	0.75%	1.31%	-2.28%
Buffalo-Niagara Falls, NY	-1.49%	-2.95%	-8.99%	-1.25%	-2.52%
Rochester, NY	-0.36%	-0.10%	0.60%	2.10%	-6.01%
Syracuse, NY	1.35%	-2.06%	0.70%	-1.41%	-5.03%
United States	1.49%	0.48%	2.44%	1.84%	1.98%

The duration of the economic contractions in upstate New York has been substantially longer than national recessions as well. Will the next recession follow these patterns, or has the economic restructuring of the region made it less sensitive to cyclical downturns? For some insight into this question, we turn to what has happen to the Buffalo region over the last 15 years.

Figure 4. Buffalo MSA Total Employment 1991 - 2006

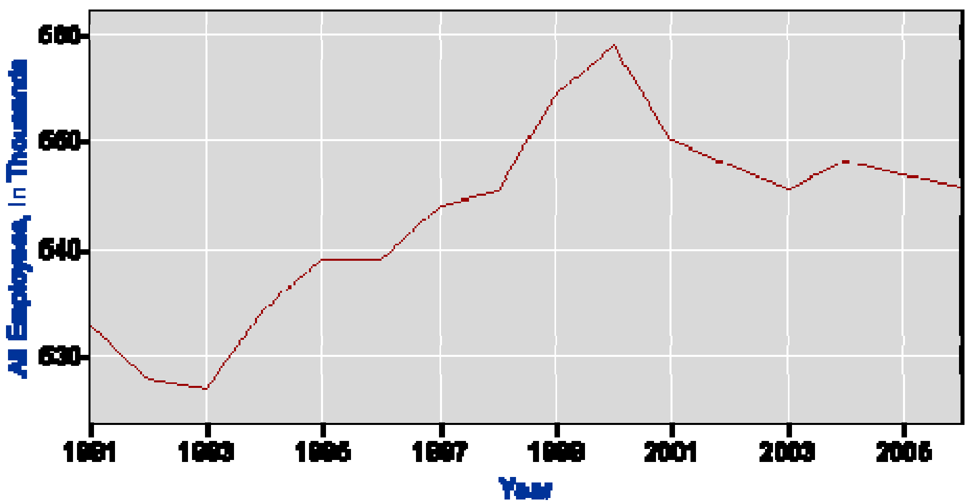


Figure 4 shows the annual employment levels for the Buffalo metropolitan area as released by the Bureau of Labor Statistics. On this basis, through the end of 2006 Buffalo had not yet recovered to its precession levels of total employment. Even on a monthly basis, total employment through November 2007 had not yet reached its December of 2000 level.

The continuous decline in the goods producing sectors of the upstate metropolitan areas is an important contributing factor to the continuing decline in earnings per worker relative to the rest of the nation. The employment pattern in this sector is presented in Figure 5. As in the other major upstate metropolitan areas, Buffalo's goods producing sector is not likely to return to its pre-recession levels.

In 1998, durable goods manufacturing (on a SIC basis) directly generated over $3.2 billion of wages and salaries in the Buffalo metropolitan area. Nearly a decade later it accounted for a little over $3.1 billion (on a NAICS basis). This decline in nominal terms is approximately $100 million and reflects a reduction in proportion from 19.8% of total wage and salary disbursements in 1998 to 15.1% in 2006.

Figure 5. Buffalo MSA Goods Producing Employment
1991 - 2006

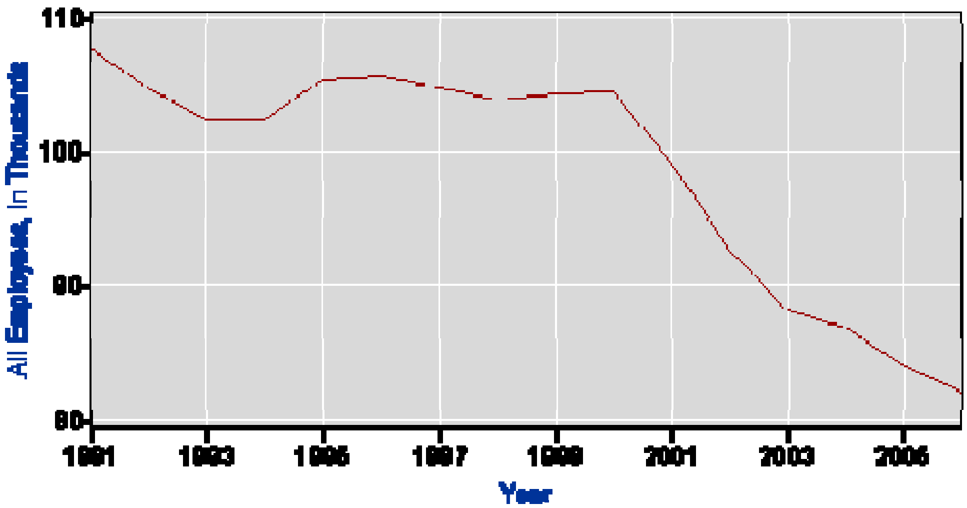
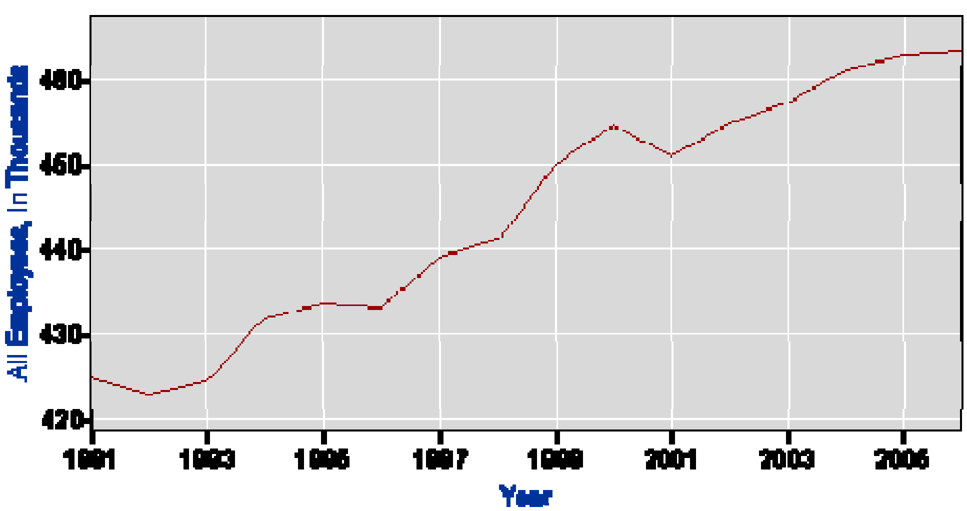


Figure 6.   Buffalo MSA Service Providing Employment
1991 - 2006



The other side of the employment picture has been the growth of the service providing sector. While the average earnings per worker has been lower in this sector than in the goods producing sector, a decade of declining goods producing employment and expanding service providing employment has not yet led to a decline in overall earnings per worker. This suggests that the Buffalo region is attracting higher than average service providing employment, while losing its lower than average durable good jobs. Our May newsletter will examine these questions directly once the BEA compensation information is available in more detail. The new UAW contracts and the loss of American Axle may change the region's earnings patterns.

One positive development from the last recession is the relative impact it had on the unemployment rate in Buffalo. For most of the last recessionary period, the unemployment rate in the region was near or lower than the national average. It was below the New York State average as well. This may well reflect the changing nature of the local labor market, but it is difficult to say in a region that has continuously lost population, and potentially, members of its labor force.

Lower cost per unit in service sector makes Western New York an attractive location for many types of firms employing skilled service workers. Unfortunately, many of the firms that have found Western New York appealing of late have been in the financial services industry, which appear to be leading the nation into an economic slump.

Even though Western New York has not benefited from the most recent national economic expansion in terms of employment as has the remainder of the nation, perhaps the national economic decline will help improve the region's economic base. This would be the case if the economic problems of the financial service industry prompt economic re-location to the region in the pursuit of lower costs of production.

Conclusion

We see a significant increase in the likelihood of a national economic contraction. The combination of high energy costs, a falling dollar, low levels of consumer confidence, an impending credit crunch and an uncertain bottom to the losses from the sub-prime mortgage mess, placed the Fed in a difficult position. They must decide whether to set monetary policy to avert recession or to control an accelerating price level that may follow the recent increases in oil prices and related products. As the Fed walked this tightrope during the fall, it may have tried to do a little of both and essentially failed at both. If a national recession ensues in 2008, we would probably see the traditional detrimental impact on the durable goods sector, which is still a significant player in the local economy. Dramatic declines in the financial services sector could have an adverse affect on the local service providing sector which has become increasingly important over the last 10 years. If, however, the Fed succeeds in stabilizing the credit markets, without stimulating substantial increases in inflation; then the local economy should be able to continue along its long term path, without additional shocks.

NATIONAL, STATE & LOCAL BUSINESS INDICATORS

NATIONAL INDICATORS	2006:III	2007:I	2007:II	2007:III	% change 2006:II - 2007:II
Real GDP (billions of chained 2000$) (1)(a)	11,336.7	11,412.6	11,520.1	11,658.9	2.8
US Personal Income (billions of $)	11,030.9	11,469.2	11,577.3	11,746.7	6.5

	Dec-06	Oct-07	Nov-07	Dec-07	% change Dec-06 - Dec-07
Leading Indicators Index (1996=100) (4)(a)*	138.4	136.9	136.3		-0.94
Consumer Price Index (1982-84=100) (2)	201.800	208.936	210.177	210.036	4.08
Exchange Rate Canadian cents/US $ (3) (b)	85.8	105.8	100.0	99.4	15.87
10 Year Treasury Note Yield (%) (3) (b)	4.71	4.48	3.97	4.04	-0.67
3 Month Treasury Bill Yield (%) (3) (b)	5.01	3.94	3.15	3.36	-1.65
S&P 500 Stock Index (3) (b)	1,418.3	1,549.4	1,481.1	1,468.4	3.53
Dow-Jones Industrial Average (3) (b)	12,463.2	13,930.0	13,371.7	13,264.8	6.43
LABOR MARKET TRENDS (2)					
Nonag Civilian Employment					
US (1000's)(a)	137,167	138,362	138,477	138,495	0.97
NY State (1000's)(a)*	8,655.1	8,727.6	8,722.4		0.84
WNY (1000's)*	552.0	554.4	553.4		0.36
Unemployment Rate (%)					
US (a)	4.5	4.8	4.7	5.0	0.5
NY State (a)*	4.1	4.6	4.6		0.4
WNY*	4.5	4.3	4.5		0.0
Ave. Weekly Hours in Mfg. US (a)	41.0	41.2	41.3	41.1	0.24
Ave. Weekly. Earnings in Mfg. US ($)(a)	694.95	713.17	716.56	713.09	2.61
Ave. Weekly Earnings (1982$)(a)*	283.25	281.62	280.27	280.56	-0.95
WNY EMPLOYMENT BY SECTOR (1000's) (2)*					
Natural Resources, Mining & Construction	18.6	21.3	20.2		0.50
Manufacturing	60.9	58.9	58.9		-3.13
Trade, Transportation & Utilities	105.9	102.2	103.7		-0.96
Durable Goods	38.3	35.8	36.1		-5.00
Finance Activities	35.5	36.8	36.7		4.56
Service Providing	472.5	474.3	474.3		0.81
Government	96.7	94.9	95.2		-1.45

(1) US Dept. of Commerce
(2) US Dept. of Labor
(3) Wall Street Journal
(4) The Conference Board

(a) Seasonally Adjusted
(b) End of month data
*Nov-06-Nov-07 % change