

Western New York ECONOMIC NEWS

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Richard J. Wehle School of Business

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The last two editions of this newsletter have expressed our concern about national economic contraction and the possibility that the US had already entered a recession. The uncertainty has been reduced and it now seems clear that the nation and the region will suffer from economic contraction, the only questions remaining are how deep and how long. The financial markets crisis has already spilled over into the NY State budget (projected to be in deficit by \$9.1 billion) and will undoubtedly also be reflected in lower future employment and income levels throughout the region. Housing markets in the country have seen dramatic declines in prices and the accompanying reductions in property taxes. Since Western New York did not participate in the unsustainable growth of this sector, it will likely not decline as much. However our historic pattern has been to fall more deeply into recession, stay depressed longer and to recover less fully. The effects of the coming economic contraction will have to play out before we know if those patterns persist. The full text for this newsletter and links to data sources are available at <http://www.canisius.edu/wnyeconomicnews>.

The National Economic Outlook

Benchmark revisions to the National Income and Product accounts show that the real GDP contracted by .2% during the fourth quarter of 2007. In 2008:I and 2008:II, real GDP grew by .9% and 3.3%, respectively (see Figure 1). The old definition of recession required that real GDP show zero growth or decline for two consecutive quarters. Under this definition, the U.S. economy is not in a recession. The National Bureau of Economic Research, the official arbiter of business cycles in the U.S., uses a more complicated analysis in determining business cycle turning points. One series that they pay particular attention to is payroll employment. Payroll employment (see Figure 2) has been declining each month since December 2007. Typically, a nine month decline in payroll employment would indicate that the economy is in recession. In addition, the unemployment rate has exhibited an upward trend and presently stands at 5.7%, 1.3 percentage points higher than in early 2007. The disparity between the GDP and payroll employment data is likely due to the relatively strong performance of exports. The national economy is suffering from severe problems in the financial sector that cloud the outlook for a continuation of economic growth and will likely result in recession.

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Figure 1. Real GDP Growth Rates (2005:Q1 - 2008:Q1)

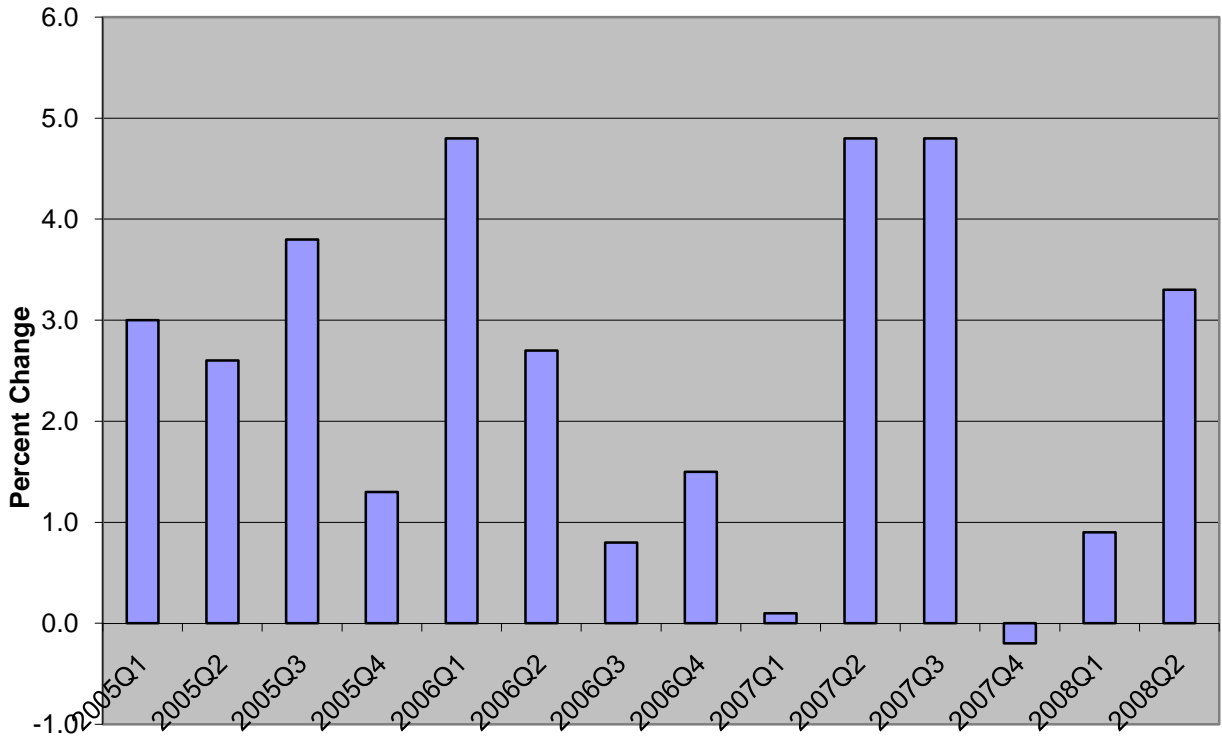


Figure 2. US Payroll Employment and the Unemployment Rate



In our opinion, there is a ninety-nine percent probability that the economy is presently in recession. The recent financial market meltdown brought about by the dissipation of the housing market bubble has ensured this. Several large investment banks have failed as problems in the credit markets begin to unwind. The Fed responded to these difficulties by enabling the March 2008 takeover of Bear Stearns by J.P Morgan Chase. They opted to guarantee the paper that was held by Bear Stearns in order to facilitate the takeover. In addition, the Fed has continued to pump liquidity into the markets through their discount window facilities, but this action has been insufficient to cure the systemic difficulties that have continued to plague financial system. Fannie Mae and Freddy Mac have been taken over by the U.S. Treasury in order to prevent their failure. Lehman Brothers filed for chapter 11 bankruptcy on September 15, Merrill Lynch was forced into an acquisition by the Bank of America, and the Fed and U.S. Treasury directly intervened in the market with their \$85 billion bail-out of the insurance giant AIG. A plan for the rescue of the financial markets has been proposed by U.S. Treasury secretary Paulson that involves a \$700 billion appropriation of taxpayer dollars and the creation of an institution to deal with the toxic mortgage backed securities on the balance sheets of so many firms in the financial markets industry. Secretary Paulson's proposal is to create an institution much like the Resolution Trust Company which dealt with the Thrift industry debacle of the 1980's and 1990's that would purchase these assets. This proposal is designed to improve liquidity in the marketplace and is being debated by Congress at present.

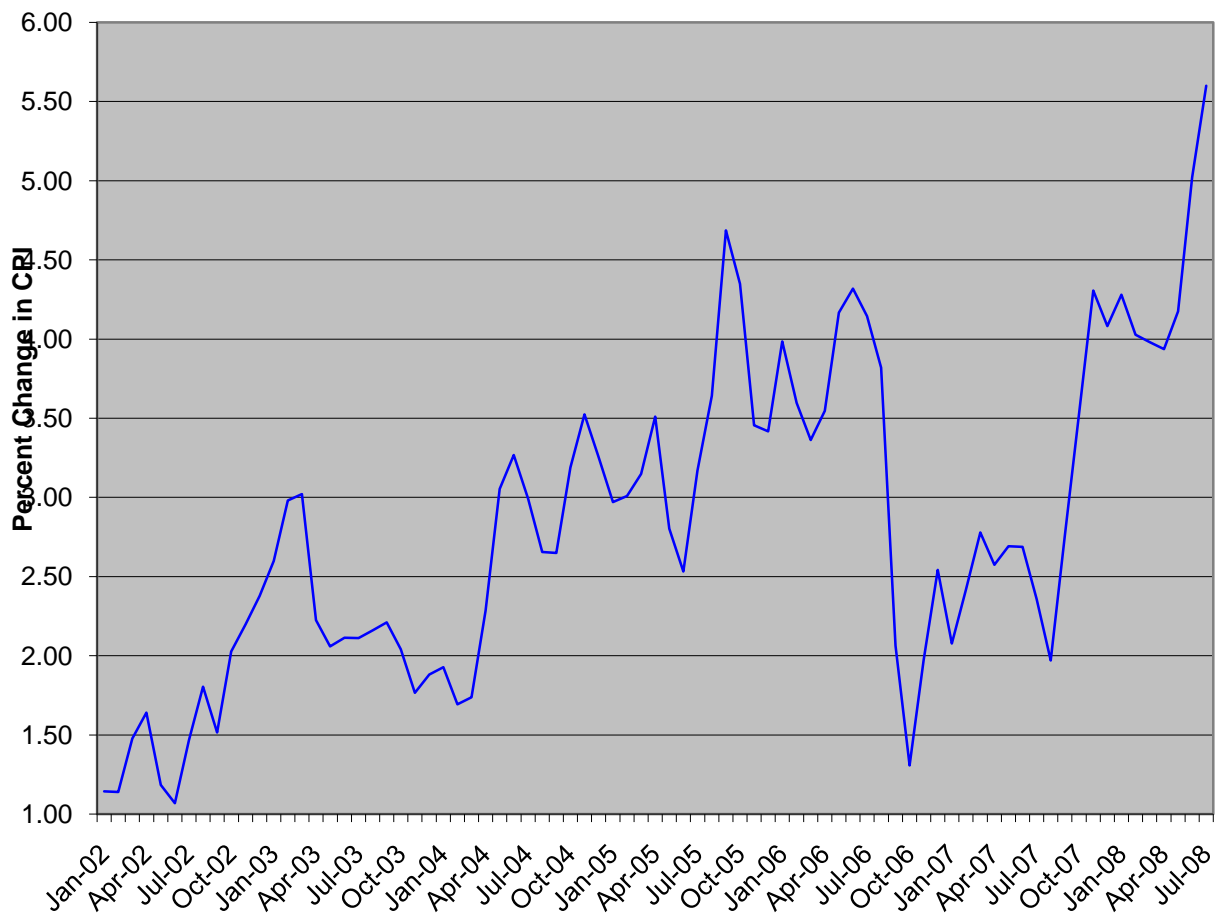
In the best case scenario, if the market is overreacting to the downward movement of housing prices, the RTC-like agency will be able to hold these securities until the market settles down and resell them at higher prices in the future. This would result in a situation where the government could at least break even on the investment that they make. In the worst case scenario, the housing market continues to decline and \$700 billion will be an insufficient appropriation. In this case, the national debt grows by another trillion dollars or so.

A fundamental problem that we have with the rescue of private companies by federal government is that the free market is not allowed to operate to punish those firms that have made bad decisions by taking excessive risks and leveraging themselves to the hilt. It could be argued that these firms should be allowed to go out of business. The crux of the issue is whether the national economy will enter a recession of long duration and severe magnitude if the government does not act decisively. The debate in Washington appears to have coalesced on a position that a lack of intervention is out of the question. It is very likely that we have not seen the end of this crisis. This will certainly impede growth of the national economy.

The government bailouts of Fannie, Freddy, Bear Stearns and AIG have emboldened American automobile executives to ask for their share of taxpayer handouts. We wonder whether there will ever be an end to bailouts once they start. One must recognize that a capitalistic system will destroy those firms whose management makes poor decisions and takes excessive risks. However care must be taken that bad firms do not destroy good firms in the process.

The Federal Reserve has had a difficult time managing the balance between an economy on the verge of recession, an accelerating inflation rate far above their target range, and a financial market in the midst of meltdown. The Fed kept the federal funds target at 2% during their September 16 meeting. With inflation running in excess of 5% (see Figure 3), this was not a surprising development.

**Figure 3. CPI Inflation Rates
(Twelve Month Percent Change)**

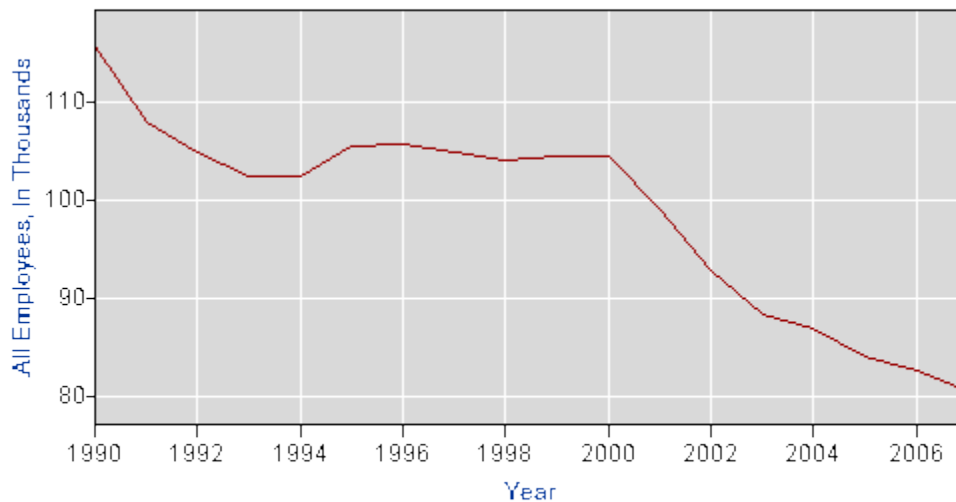


Crude oil prices have come off their unprecedented heights in the \$150 per barrel range to less than \$100 per barrel. This, along with the U.S. dollar's recent recovery is a positive economic development unless its relative strength is due to a dramatic economic decline in Europe and/or Asia. If that is the case, we should expect to see weakness in the export sector that has provided some of the strength and stability in the US over the last two years.

The Economic Outlook for the Buffalo Region

How can the Wall Street crisis turn into a Main Street crisis in Buffalo and the rest of Western New York? The linkage from the financial sector to the economy of real goods and services is somewhat complex, but worthy of study. In addition, Western New York

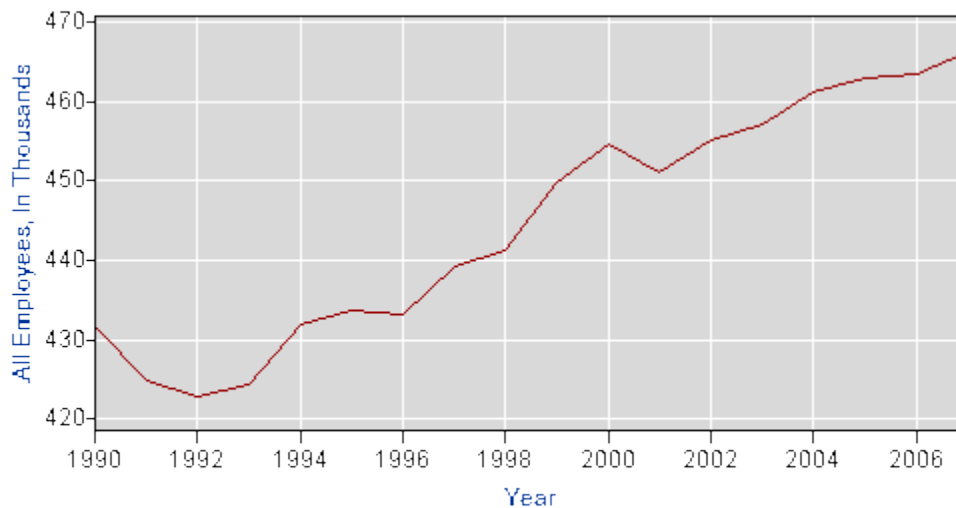
**Figure 4a: Total Employment in the Goods Producing Sector
Buffalo MSA: 1990 - 2007**



has become increasingly dependent on its new financial services industries to make up for declines in the goods producing sector. Problems in the national financial markets could have a direct impact on the local economy. In other words, Wall Street could be Main Street Buffalo.

As shown in figures 4a and 4b, there has been a fairly robust growth in service providing employment since the recession of 1991, interrupted only by the recession of 2001. During that period, financial services employment has grown by 16% to about 34,000 workers. While alone this may not seem impressive, contrast this growth to the 36% decline in durable goods production, to about the 36,000 worker range. The current financial crisis could directly affect the 34,000 financial service workers, while indirectly harming the 36,000 durable goods workers. It is this latter group that could suffer the impact of the severe reduction in consumer expenditures resulting from the unavailability of credit and the loss of wealth resulting from lost housing, stock and pension values.

**Figure 4b: Total Employment in the Service Providing Sector
Buffalo MSA: 1990 - 2007**



While the two sectors appear to be about the same size in terms of employment, the impact of each lost durable goods job on the local economy could be about twice as large as each lost job in the financial services sector, since durable goods workers earn approximately twice as much per annum as financial services employees.

Durable goods production has historically been very sensitive to changes in the business cycle. As products whose consumption can be delayed, reductions in durable goods orders have long acted as a leading indicator for economic contractions. Recently durable goods orders were reported to have declined 4.5% from the previous year. The financial markets crisis can compound this problem if the lack of personal credit further reduces the ability of consumers to obtain big ticket durable goods, or the lack of commercial credit destroys significant components of our distribution system. If the latter occurs, many more Americans will learn what most economists already know, there is no real difference between Wall Street and Main Street.

On a more positive note, the financial markets crisis has moved our banking system into one that is more concentrated and dominated by super sized international banks. The presence of HSBC and the increasing commitment of Citigroup to the region can have a significant impact on regional income. This requires a stability of these institutions that may be more likely now than before. However, if international financial institutions of enormous size are the future in the banking industry, what is the future of M&T Bank, the seemingly successful regional bank that might still consider Buffalo as its home? Only time will tell.

NATIONAL, STATE & LOCAL BUSINESS INDICATORS

NATIONAL INDICATORS	% change				
	2007:II - 2008:II				
	2007:II	2007:IV	2008:I	2008:II	2008:II
Real GDP (billions of chained 2000\$) (1)(a)	11,491.4	11,620.7	11,646.0	11,740.3	2.2
US Personal Income (billions of \$)	11,577.5	11,872.1	11,960.5	12,174.2	5.2

	% change				
	Aug-07 - Aug-08				
	Aug-07	Jun-08	Jul-08	Aug-08	Aug-08
Leading Indicators Index (1996=100) (4)(a)	103.6	102.0	101.3	100.8	-2.70
Consumer Price Index (1982-84=100) (2)	207.917	218.815	219.964	219.086	5.37
Exchange Rate Canadian cents/US \$ (3) (b)	94.7	102.0	102.4	106.2	12.12
10 Year Treasury Note Yield (%) (3) (b)	4.55	3.98	3.99	3.83	-0.72
3 Month Treasury Bill Yield (%) (3) (b)	4.01	1.90	1.68	1.72	-2.29
S&P 500 Stock Index (3) (b)	1,474.0	1,280.0	1,267.4	1,282.8	-12.97
Dow-Jones Industrial Average (3) (b)	13,357.7	11,350.0	11,378.0	11,534.6	-13.65

LABOR MARKET TRENDS (2)

Nonag Civilian Employment					
US (1000's)(a)	137,756	137,617	137,557	137,473	-0.21
NY State (1000's)(a)	8,749.6	8,774.5	8,778.1	8,781.3	0.36
WNY (1000's)	544.6	554.9	545.5	546.6	0.37
Unemployment Rate (%)					
US (a)	4.7	5.5	5.7	6.1	1.4
NY State (a)	4.6	5.3	5.2	5.8	1.2
WNY*	4.5	5.7	6.0	6.0	1.5
Ave. Weekly Hours in Mfg. US (a)	41.3	41.0	41.0	40.9	-0.97
Ave. Weekly Earnings in Mfg. US \$(a)	715.73	726.11	729.39	725.98	1.43
Ave. Weekly Earnings (1982\$(a)	282.30	275.18	273.81	275.35	-2.46

WNY EMPLOYMENT BY SECTOR (1000's) (2)

Natural Resources, Mining & Construction	17.2	19.90	20.40	20.80	20.93
Manufacturing	60.8	59.40	58.60	58.80	-3.29
Trade, Transportation & Utilities	101.2	102.90	101.50	101.70	0.49
Durable Goods	37.4	36.40	35.80	36.00	-3.74
Finance Activities	33.6	34.30	34.50	34.30	2.08
Service Providing	463.2	475.60	466.50	467.00	0.82
Government	95.5	97.50	92.10	91.30	-4.40

(1) US Dept. of Commerce

(a) Seasonally Adjusted

(2) US Dept. of Labor

(b) End of month data

(3) Wall Street Journal

(4) The Conference Board