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The national recovery from the 2001 recession continues with real GDP growing at annual rates near 4%. The economy's resilience to the substantial energy price shocks that occurred during the fall has been impressive, but sustained energy price increases would cause some concern about the prospects for continued expansion. Federal Reserve action has again pushed short term interest rates higher, resulting in short term rates that exceed long term rates. Inverted yield curves have preceded every recession since the 1960s and are a cause for worry about the health of the current expansion. While real GDP has continued to increase, real average hourly earnings have declined somewhat and are at the same level that they were during the 2001 recession. On the local scene, employment growth continues in the lower wage service sector, with declining employment in the higher wage goods producing sector. This trend is one of the factors contributing to the fiscal deterioration of local government in Erie County and throughout much of upstate New York.

The full text and supporting documents for this newsletter appear at the following internet address: <http://www.canisius.edu/wnyeconomicnews>.

The National Economy

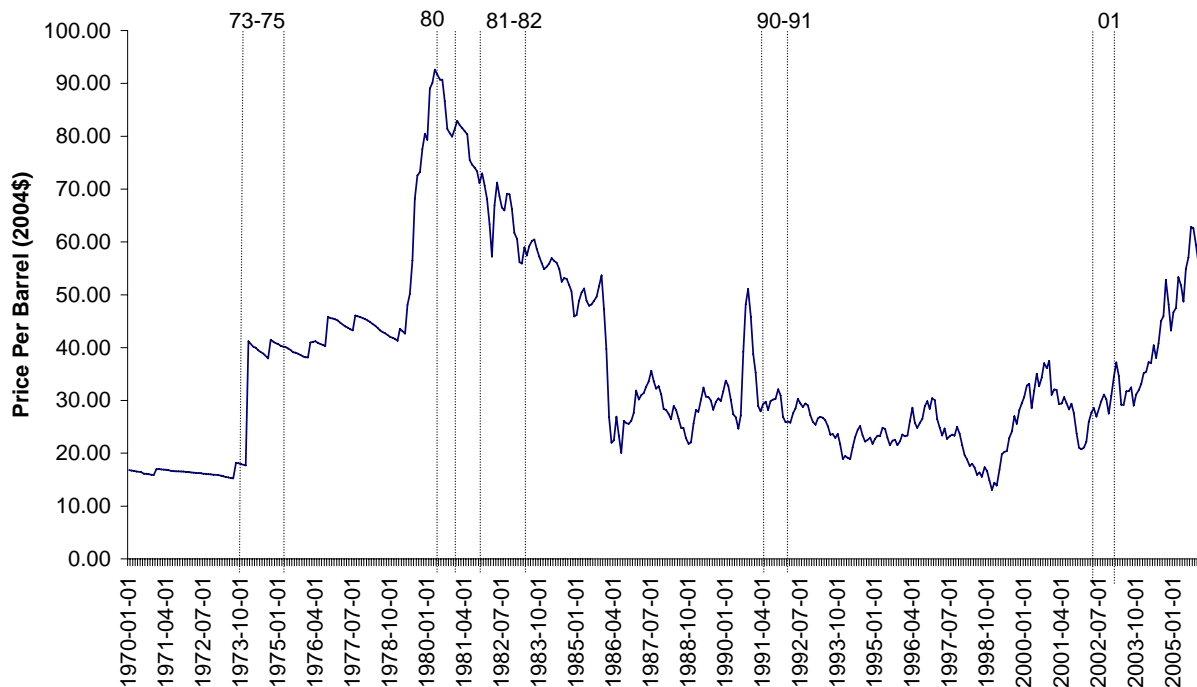
Final estimates of real GDP in 2005:Q3 show the national economy growing at an annual rate of 4.1%, after growing at annual rates of 3.3%, 3.8%, and 3.3% during the period 2004:Q4-2005:Q2 www.bea.gov. The economy appears to have weathered the hurricane induced energy shocks of September very nicely. National average retail gasoline prices are presently \$2.24 per gallon, retreating from their post hurricane high of almost \$3.05 in September 2005. The magnitude of the impact of the energy shock upon GDP growth will not be known until late January when advance estimates of GDP during the fourth quarter of 2005 will be reported.

Figure 1 shows the real price of a barrel of West Texas intermediate crude oil measured in 2004 dollars. Nominal oil prices have been adjusted by the economy-wide consumer price index to place them on a 2004 constant dollar basis. The real average monthly price per barrel of crude oil has trended upward since 1999, peaking at approximately \$63 per barrel during September 2005. During the October-December 2005 period, oil prices have backed off the September peak.

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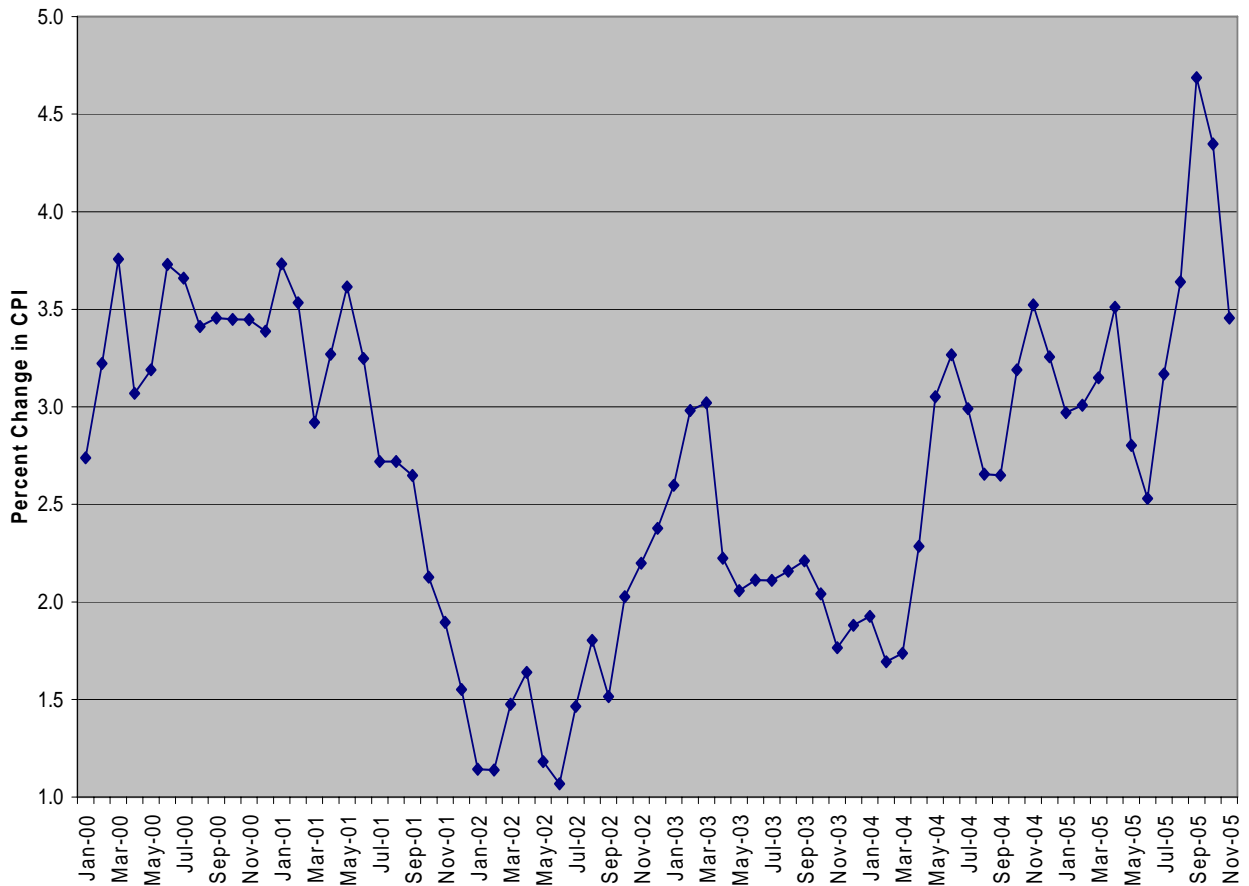
Figure 1: Real Price of a Barrel of West Texas Intermediate Crude Oil (2004\$)



So far, the most notable impact of the energy shock on the national economy has been on the rate of consumer price inflation. Figure 2 shows the inflation rate based on 12-month changes in the Consumer Price Index (CPI) from January 2000 to the present. Increased energy prices have contributed greatly to the rising rate of economy-wide inflation to a level that has not been experienced since 1991. CPI inflation accelerated to 4.7% in September before retreating to 3.5% in November. Whether the acceleration of inflation is permanent or transitory depends on how the expectations of consumers and firms are influenced by the rise in the inflation rate. Based upon the data published to date, it appears that the hurricane induced energy shock had only a transitory impact on the US economy.

The Federal Open Market Committee has continued its policy of raising the federal funds rate target by 25 basis points at each of its meetings. They raised their target rate to 4.25% during their December 13, 2005 meeting, deciding that the risks of accelerating inflation outweigh the risk of a slowdown in economic activity, which higher interest rates could bring. Three month Treasury bill yields are presently at 4.16%, having risen from 2.32% over the past year. The yield curve continues to flatten with ten year Treasury note yield at 4.37%. There has been a marked flattening of the yield curve over the past year, culminating in an inversion on December 29. The Treasury yield curves from January 3, 2005 and January 3, 2006 are shown in Figure 3. Presently, the yield curve is negatively sloped from the 6-month maturity to the 5-year

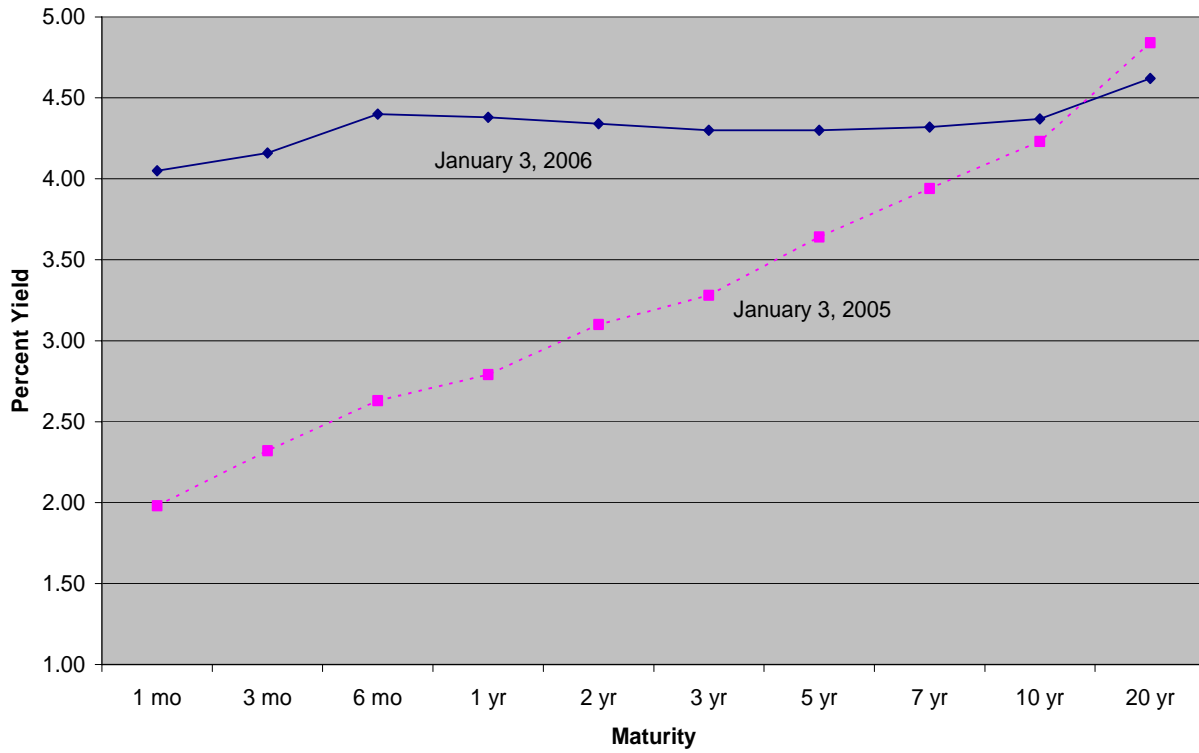
Figure 2: CPI Inflation Rates (Twelve Month Percent Change)



maturity. The presence of a negatively sloped yield curve is often interpreted as a harbinger of recession. In fact, an inverted yield curve has preceded economic downturns by five quarters or less in each recession since the mid 1960's.

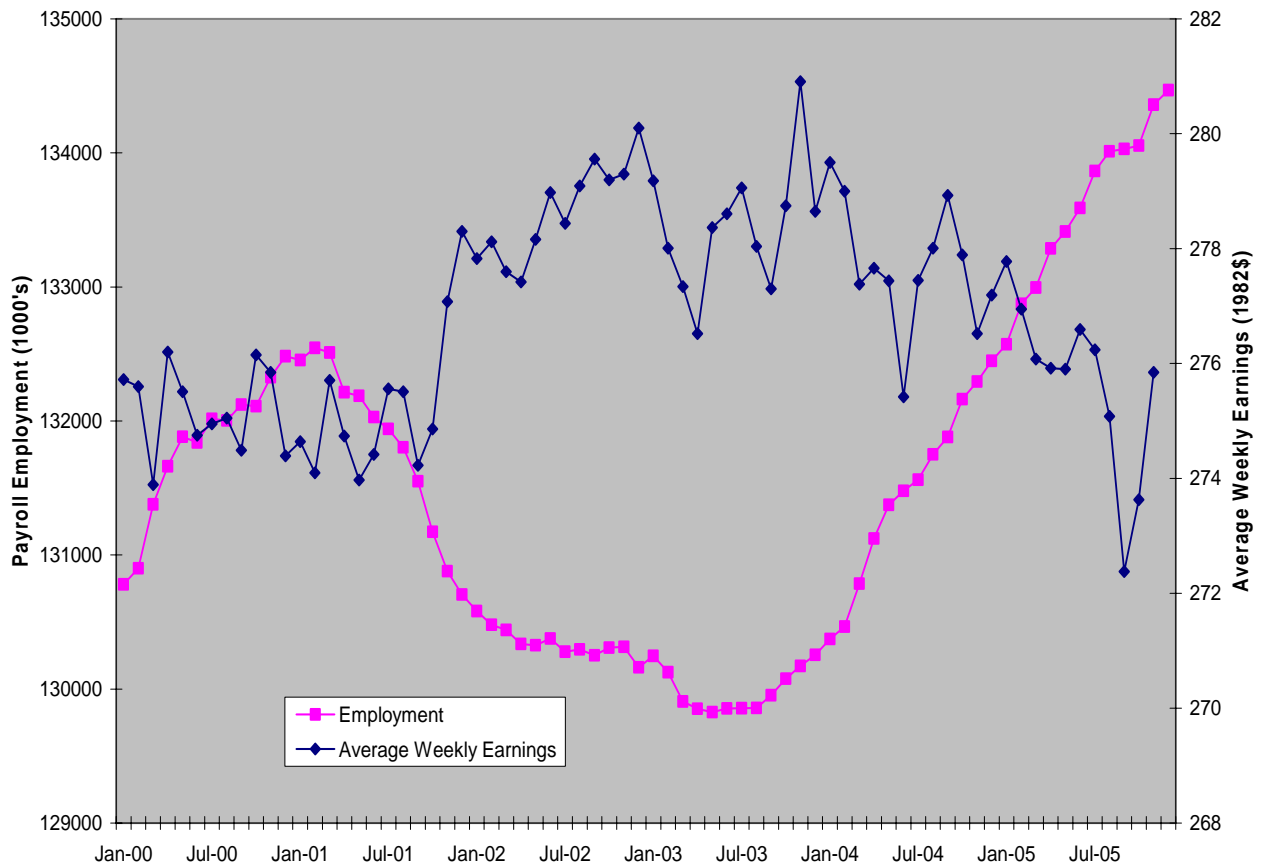
An explanation of why inverted yield curves lead to recession can be found in the credit crunch hypothesis. Since banks typically borrow short and lend long, if short term rates are higher than long term rates, a bank's cost of funds will approach the return they receive from lending these funds. This gives the banking sector a disincentive to lend and results in a reduction in lending activity. This in turn, leads to a credit crunch, a reduction in the money supply, and a reduction in aggregate economic activity. A national recession would have ominous consequences for the Western New York economy.

Figure 3: U.S. Treasury Yield Curve



On a positive note, labor markets have continued to improve as the economic recovery ages. Businesses have added almost 4.5 million new jobs to payrolls since May 2003. Although the number of new jobs added is impressive, the wages that these jobs pay has trended downward since November 2004. This is consistent with the replacement of high paying manufacturing jobs with lower paying service sector jobs. As we have shown in previous issues of this newsletter, the same trend, in spades, has been experienced in Western New York. U.S. payroll employment and real average weekly earnings since January 2000 are shown in Figure 4.

Figure 4: U.S. Payroll Employment and Real Average Weekly Earnings: 2000-2005



We voiced our concerns about a worst case scenario for the economy in the past two issues of this newsletter. This would have involved a continued escalation in energy prices causing an increase in inflation expectations and a vigorous interest rate hike by the FED. Although this scenario has not developed, we are assigning a 25% probability of recession within the next year.

The State of the Upstate Economies

In previous issues, we have wondered if the long term decline in the upstate metropolitan areas reflects a redistribution of activity within the national economy or if it is indicative of an impending restructuring of the national economy. The replacement of highly paid goods producing jobs with less well paid service providing employment in Western New York and the other upstate metropolitan areas, could eventually lead to a reduction in earnings per worker in the region (see Table 1).

Table 1. Differentials in Growing and Declining Sectors of the Upstate Economy: 2003 Earnings Per Worker

Metropolitan Area Name	2003 Earnings Per Worker	
	Declining Goods Producing Sectors	Growing Non-Goods Producing Sectors
Buffalo-Niagara Falls, NY (MSA)	\$59,457	\$27,853
Rochester, NY (MSA)	\$58,401	\$29,217
Syracuse, NY (MSA)	\$55,630	\$30,225
U. S. Total	\$42,762	\$35,846

The variation in constant dollar average weekly earnings that has occurred since January 2002, shown in Figure 4, leaves the real purchasing power of the 132 million payroll employees in this country at the same level today as they were at the bottom of the 2001 recession. This has occurred in the face of rather healthy increases in real GDP. The question remains: is the change in economic activity that results in the changes outlined in Table 2 unique to upstate New York, or is it the precursor to a long term structural change in the national economy? Earnings per worker are an important indicator of the changes that have and may continue to occur both regionally and nationally.

Table 2. Growth & Change in the Upstate Areas: 1980-2000

Metropolitan Area	Population			Per Capita Income			Per Capita Income as % of US		
	1980	1990	2000	1980	1990	2000	1980	1990	2000
Buffalo-Niagara Falls, NY (MSA)	1,241,275	1,190,943	1,168,952	\$9,938	\$18,832	\$27,209	98%	97%	91%
Rochester, NY (MSA)	972,728	1,004,989	1,038,462	\$10,799	\$20,791	\$29,327	107%	107%	98%
Syracuse, NY (MSA)	642,764	661,505	650,424	\$9,441	\$18,841	\$27,007	93%	97%	90%

As earnings and income in the upstate regions continue to sink relative to the national economy, there will be impacts on the ability of local governments to continue to provide public services at the levels that the local population has come to expect. The burdens on local governments are manifested in budget crises and the discontinuation of services that are visible to the public. The two major local public sector expenditure responsibilities are elementary and secondary education, along with health and income maintenance (welfare) programs. With the exception of the city of Buffalo, local education is provided by fiscally independent public school districts that bring budgets

directly to voters for approval. This process gives some degree of control to the residents who are responsible for the own-source revenue raising responsibility, which are primarily the taxes that go along with the education aid school districts receive. In the cities of Buffalo, Rochester and Syracuse, the school district budget is part of city government finances, accounting for as much as 75% of city government expenditures. These fiscally dependent school districts offer local voters less control over local education spending than their suburban counterparts.

In the case of social service expenditures, county governments in New York State have little control over the level of local spending and are responsible for raising approximately 20% of the revenues needed to finance this spending. The Erie County Medical Center is an example of a discretionary expenditure item, but past financial arrangements have made a complete separation impossible at the moment. Table 3 shows the relative importance of social service programs in the budgets of the central counties in the three major upstate metropolitan areas.

Table 3: Differentials in Social Service Programs Burdens on County Governments: 2002

Metropolitan Area Central County	2002 Social Service Expenditures		
	Health & Hospital Expenditures	Public Welfare	Percentage of Direct General Expenditures
Erie County	\$303,914,000	\$538,718,000	76%
Monroe County	\$107,819,000	\$447,595,000	54%
Onondaga County	\$58,871,000	\$261,677,000	46%
New York State Counties	\$8,231,453,000	\$14,049,491,000	51%

According to the 2002 Census of Governments, health, hospital and public welfare expenditures comprised 76% of direct general expenditures in Erie County. That leaves very little flexibility for the county government during periods of tight budgets. As long as the mandated expenditures remain in place and the current cost structure of delivering local governmental services remains the same, there is little to cut except highly visible, and controversial, services like parks, recreation, highway maintenance, and police patrols. One might ask what can be done, and the answer is wrapped up with the source of the problem. For several years we have been pointing out the long term decline in real earnings per worker and the transformation of the local economy.

Our falling relative per capita income indicates a declining ability to generate local tax revenues. Erie County's property values grew by 1.4% per annum from 1999 through 2004, compared to the national average of 6.3% per year. This stagnant growth rate is

probably associated with the growth of the lower paying service sector and the decline of the higher paying goods producing sector. It is local income that drives local consumption and property values. Stagnant tax bases linked to the decline in earnings is generating the squeeze in local government budgets.

Additionally, the cost structure of local government, primarily driven by wage costs, has risen relative to local revenue raising capacity. Table 4 shows the changing relationship between private sector earnings per worker and the local government earnings per worker since the BEA began isolating local government earnings. At the beginning of the major restructuring of the local economy in 1979, private sector earnings per worker were 15% higher than per worker earnings of local government employees. In 2003, the average earnings of private sector workers is 21% lower than its local government counterpart. The earnings of local government workers have risen far faster than earnings in the private sector, and in fact, substantially exceed private sector earnings per worker. This has limited the ability of the tax base to finance local government.

Table 4: Local Public Sector and Private Sector Earnings Per Worker: 1979 & 2003

Buffalo Metropolitan Area	1979	2003
Private Sector Earnings per Worker	\$14,498	\$34,940
Local Government Earnings per Worker	\$12,575	\$43,987
Ratio of Private Sector to Local Government Earnings per Worker	115%	79%

This pressure on local taxpayers has led to a resistance to increasing tax rates on a relatively stagnant tax base. One would suspect that this resistance will continue and that eventually public sector employees will see wage rate adjustments similar to those that have been occurring in the private sector.

In conclusion, the national economy is in recovery, but there is little evidence of a recovery for payroll employees. The region still remains in decline that is long term in nature, but a decline that will be made far worse by a national recession. The region and its governments can no longer ignore the reality of the change and must adapt to it.

NATIONAL, STATE & LOCAL BUSINESS INDICATORS

NATIONAL INDICATORS	% change				
	2004:III - 2005:III				
	2004:III	2005:I	2005:II	2005:III	2005:III
Real GDP (billions of chained 2000\$) (1)(a)	10,808.9	10,999.3	11,089.2	11,202.3	3.6
US Personal Income (billions of \$)	9,729.2	10,073.4	10,185.7	10,231.0	5.2

	% change				
	Dec-04 - Dec-05				
	Dec-04	Oct-05	Nov-05	Dec-05	Dec-05
Leading Indicators Index (1996=100) (1)(a)*	136.9	138.1	138.8		1.39
Consumer Price Index (1982-84=100) (2)*	190.3	199.2	197.6		3.84
Exchange Rate Canadian/US \$ (3) (b)	83.4	84.7	85.7	86.0	3.16
10 Year Treasury Note Yield (%) (3) (b)	4.22	4.56	4.50	4.39	0.17
3 Month Treasury Bill Yield (%) (3) (b)	2.21	3.88	3.94	4.07	1.86
S&P 500 Stock Index (3) (b)	1,211.9	1,207.0	1,249.5	1,248.3	3.00
Dow-Jones Industrial Average (3) (b)	10,783.0	10,440.1	10,805.9	10,717.5	-0.61

LABOR MARKET TRENDS (2)

Nonag Civilian Employment					
US (1000's) (a)	132,449	134,055	134,360	134,468	1.52
NY State (1000's) (a)*	8,491.5	8,538.7	8,547.4		0.66
WNY (1000's)*	555.9	555.7	555.6		-0.05
Unemployment Rate (%)					
US (a)	5.4	4.9	5.0	4.9	-0.5
NY State (a)*	5.6	4.8	5.4		-0.2
WNY*	5.6	4.5	5.4		-0.2
Ave. Weekly Hours in Mfg. US (a)	40.5	41.0	40.8	40.7	0.49
Ave. Weekly Earnings in Mfg. US (\$)	661.77	687.6	687.2	694.7	4.97
Ave. Weekly Earnings (1982\$)(a)*	277.19	273.6	275.9		-0.48

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

Natural Resources, Mining & Construction	20.0	23.0	21.9		9.50
Manufacturing	66.3	65.8	65.3		-1.51
Trade, Transportation & Utilities	106.3	102.9	104.7		-1.51
Durable Goods	40.4	40.0	39.7		-1.73
Finance Activities	35.4	36.3	36.2		2.26
Service Providing	469.6	466.9	468.4		-0.26
Government	97.2	94.5	94.9		-2.37

(1) US Dept. of Commerce

(a) Seasonally Adjusted

(2) US Dept. of Labor

(b) End of month data

(3) Wall Street Journal

*% change is Dec-04 - Nov-05