

Western New York ECONOMIC NEWS

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The official arbiter of business cycles in the US, the National Bureau of Economic Research (NBER), has determined that the US economy entered recession in March 2001. The duration and magnitude of the recession are yet to be determined. This recession differs from those that have preceded it in several important ways, the most important of which involve consumer attitude, spending and debt. An additional factor that will affect the length and severity of the current recession is the ever-changing relationship between the US economy and the rest of the world. Over the last half of the 20th century, exports and imports more than doubled their share of US Gross Domestic Product. The effect of a broader export base is a greater vulnerability to economic fluctuations that occur in other countries. Thus, declining European and Asian economies can exert a drag on the US economy, delaying any incipient recovery. The relative growth of the importance of imports has muted the impact of traditional expansionary fiscal and monetary policy because expanded spending in the US on products made abroad will increase incomes in other countries rather than at home. This leakage of income reduces the multiplier effect of increased government spending and increased consumption induced by tax reductions. The departure from past patterns makes economic forecasting more difficult. This newsletter will look at how the Western New York economy has been harmed by past economic contractions and will assess how the changing nature of the local region's economic base could affect the current relationship. As is the usual case a complete version of this newsletter can be viewed on the web at: <http://www.canisius.edu/wnyeconomicnews>.

The National Economic Outlook

Final data for third quarter 2001 real GDP show the US economy declining at a 1.3% annual rate, after posting a 1.3% and .3% gains during the first and second quarter. The National Bureau of Economic Research Business Cycle Dating Committee (www.nber.org) has determined that business activity in the US peaked in March 2001, officially placing the economy in recession. The unprecedented expansion, beginning in March 1991, was the longest expansion on record according to the NBER. The

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NBER dates the business cycle on the basis of monthly indicators and is not wed to the old rule that a recession is defined as two consecutive quarters of zero or negative growth in real GDP. Employment, industrial production and real sales in the manufacturing and trade sectors showed the economy peaking in March 2001. At the onset of a typical recession, real personal income less transfer payments also peak. Although this cyclical regularity has not yet occurred, the NBER chose to call the recession.

This recession has differed substantially from the past few consumer led recessions. During 2001:III, consumers continued to increase their real spending as is evident by examining the 1% increase in real consumption and the 2.4% increase in residential construction (www.bea.doc.gov). Consumer confidence rebounded quickly after the September 11 attack and consumers continued to spend. Retail sales during the fourth quarter of 2001 appear to have been better than forecasted. What factors are responsible for the economic downturn? Nonresidential fixed investment, inventories and exports, all dramatically declined during the third quarter. Gross private domestic investment declined by 10.5% during 2001:III, continuing the decline that began during the third quarter of 2000. The increasing trade deficit during 2001:III was led by a decline in exports of 18.8% while imports declined by only 13%. Clearly, this recession appears to have been led by the business and export sectors.

The December national unemployment rate stands at the 5.8%, its highest level since April 1995. Monthly US and Buffalo area unemployment rates over the period January 1990 to December 2001 are shown in Figure 1. A reversal of the downward trend in the US unemployment rate began in November 2000. The pace of the increase in the US rate began to pick up in August 2001 when the rate increased by .3% over the July rate. Since August, the US rate has increased by almost one full percentage point. There appears to be more noise in the Buffalo area unemployment rate. It seems to have begun increasing at roughly the same time as the US rate. The Buffalo and US rates appear to track one another closely until 1997 when Buffalo unemployment rate remains consistently above the US rate. This seems to lend credence to previous issues of this newsletter where Buffalo's failure to share in the 1990's growth of the national economy was outlined.

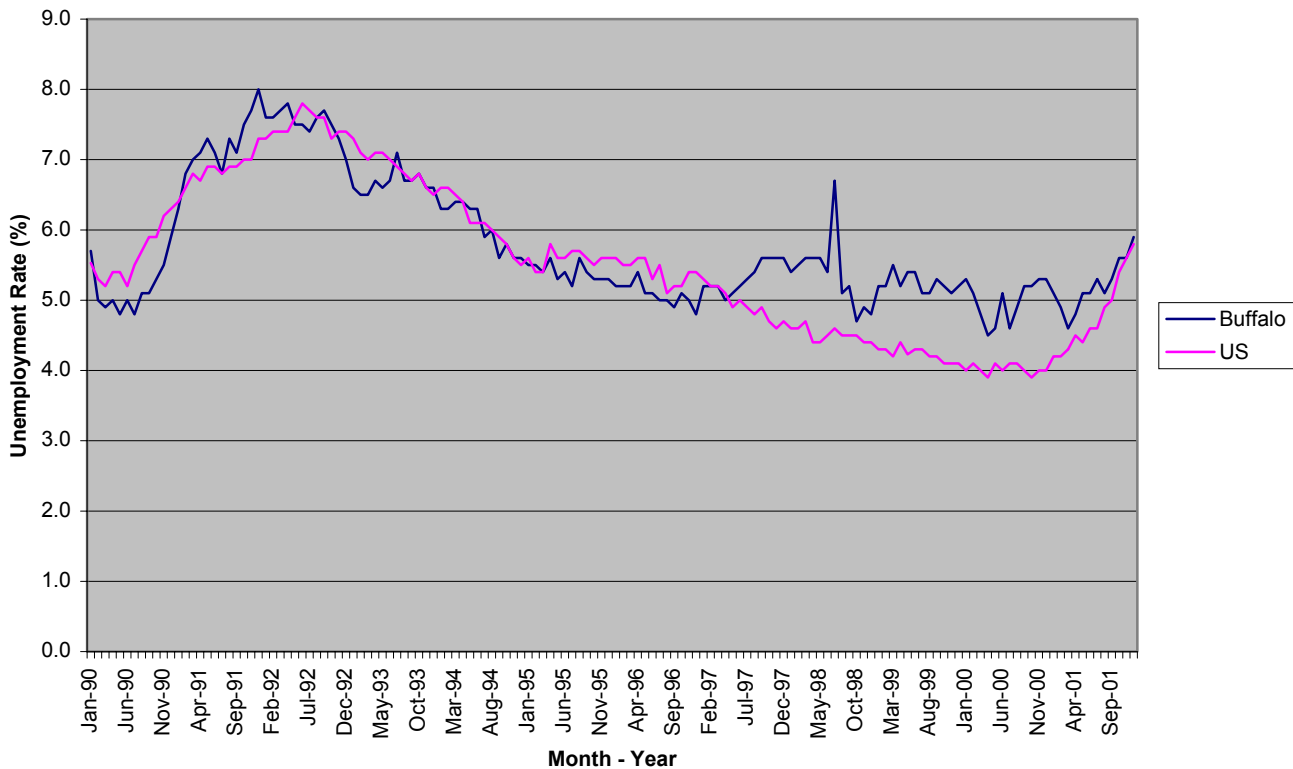
The current economic downturn has resulted in a series of substantial layoffs. The economy has shed over 1.2 million jobs since July 2001. Inflation as measured by the Consumer Price Index closed out 2001 at 2.8% compared to the 3.4% increase in 2000. On a monthly basis, the CPI has declined significantly since May 2001 when the May 2000 – May 2001 inflation rate stood at 3.62%. From December 2000 to December 2001, the inflation rate declined to 1.55% <http://www.bls.gov>.

Political problems in implementing expansionary fiscal policy to combat the current recession have resulted in no fiscal stimulus bill passing Congress. Congress and the President have continued to debate the contents of a stimulus package while the recession evolves. Republicans continue to support tax cuts while Democrats favor increments in discretionary spending. By the time these differences are worked out, if

they ever are, it is likely that the economy will have begun its recovery and the stimulus package will be moot.

Equity markets have recovered nicely after the September 11 World Trade Center disaster. The yield curve has steepened significantly with three month US Treasury yields below 1.66% and ten year US Treasury yields at 4.91% as of January 23, 2002. The Federal Reserve has continued to pump reserves into the banking system. The Fed has reduced its federal funds rate target eleven times in 2001, the latest coming at the December 11 meeting of the Federal Open Market Committee. Clearly, the Fed's use of expansionary monetary policy has lessened the severity of the current recession. There will be an expansionary effect on the Buffalo region as a result of the

Figure 1: US and Buffalo Area Unemployment Rates



Fed's activity. However, it should be noted that during the last economic expansion there was less growth locally than there was nationally. There is no reason to believe that our next recovery will be substantially different from the last.

The Economic Outlook for the Buffalo Region

If past patterns hold, then during the current economic contraction the Western New York economy will contract at a greater rate and recover less fully and at a slower rate than the nation as a whole. The relationship between earnings in the Buffalo metropolitan area and earnings in the United States are also closely related, as shown in Figure 2. Since 1969, each 1% growth in total earnings in the United States has been associated with a .9% change in total earnings from all industries in the local economy.

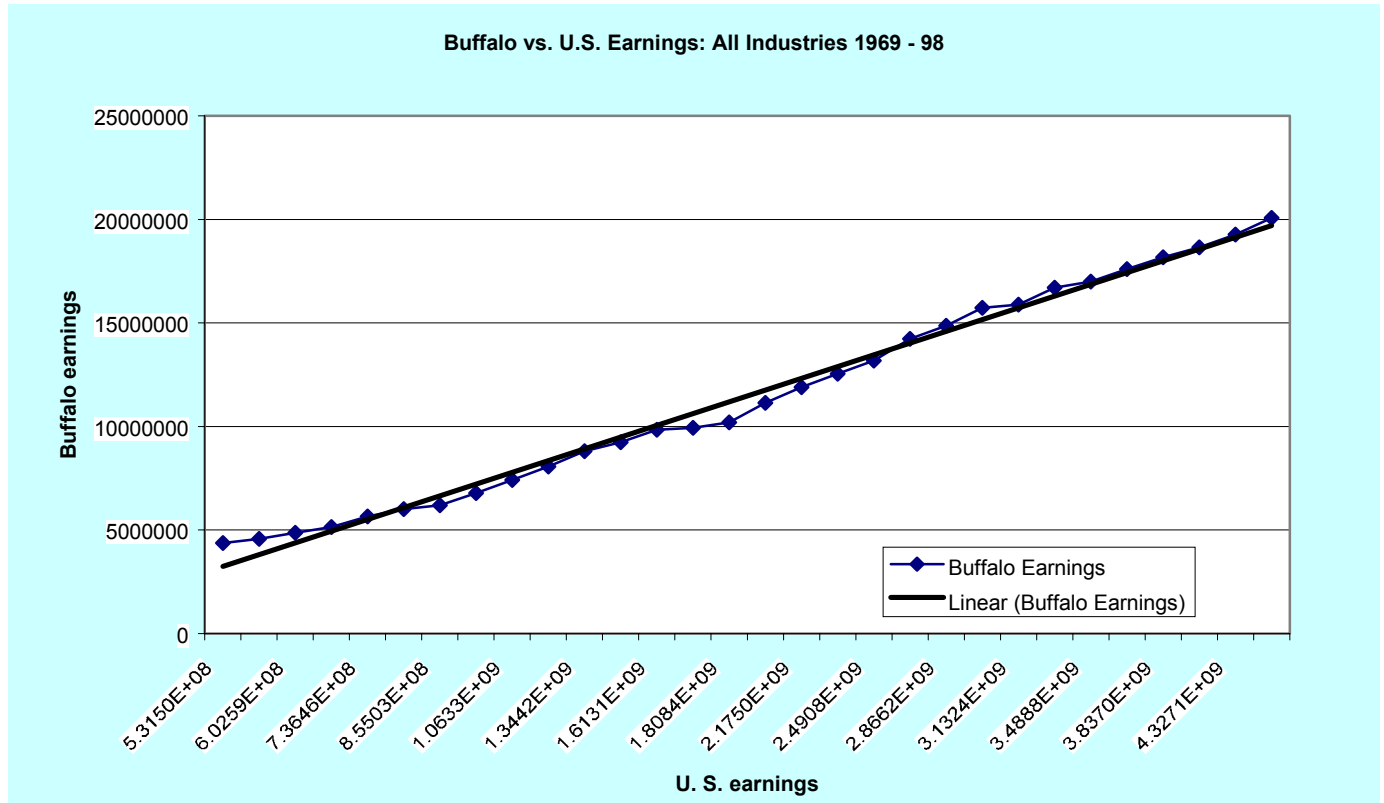
The most likely reason for this relationship is the redistribution of population and employment from the Buffalo area to the rest of the world during the period. The Buffalo economy declined more deeply and recovered less fully from each of the recessions than did the national economy. Thus earnings growth in the region during the observed period suffered relative to the national economy.

The historic effects of changing national earnings on the earnings of workers in important local industries are presented in Table 1. Not all local industries are equally sensitive to national business cycle activity. If there is a heavier concentration of an industry in the local economy than there is in the national economy, the industry is most likely producing for a non-local market. Industries producing for national or international markets are sensitive to changes in national and international income levels. As these economies slip deeper into recession, ever-lower income levels outside the region eventually begin to decrease local income.

The Western New York region also specializes in the production of public sector related services that are provided to a national or international constituency. The presence of the SUNY centers as well as the Roswell Park Cancer Institute provide engines of income generation that may be less sensitive, though not immune, to changes in the level of national and international income. Table 1 lists the two-digit (SIC) industries in the Buffalo metropolitan area where the proportion of total local earnings in each industry is at least 20% higher than the national average. The second column of Table 1 shows the percentage change in local earnings by industry for each one percent change in national income. The final column in the table shows the level of comfort we feel in the validity of the estimated relationship. We are most certain of the relationship between the U. S. economy and total earnings from all industries in the Western New York region. Thus, we are most confident in the prediction that for each 1 percent decline in total earnings nationally, there will be .9% decline in total earnings locally.

We are slightly less confident, in our predictions about what will happen in specific industries. It is reasonable to expect a change in local earnings in response to a change in national earnings for fabricated metal products; rubber & plastic goods; food; chemicals; and the apparel industry, at the rates indicated in Table 1.

Figure 2: THE RELATIONSHIP BETWEEN EARNINGS: U. S. AND BUFFALO MSA



Each 1% change in US earnings leads to a .9% change in Buffalo's earnings

The specific linkage between the local economy and the national economy is complex and is not fully understood. The four remaining local industrial sectors in Table 1 seem to exhibit no consistent relationship to changes in the national economy. Therefore, it would be imprudent to forecast local responses to changes in earnings at the national level. The changing nature of miscellaneous manufacturing in the Western New York economic base may have changed this region's traditional relationship to the national economy. Even after the massive decline in the durable goods sector in the Buffalo region, earnings from the automotive sector were a higher proportion of total earnings 1997 than they were in 1980. Disclosure rules prevent any long-term assessment of the impact of the current recession on the automobile sector, one of the most important sectors in the Western New York economy. Historically recessions have had a profound impact on this sector nationally. The fact that the current recession hasn't yet had a substantial effect on the auto industry, gives some analysts a reason to believe that we have not yet felt the full fury of this economic decline.

TABLE 1 RELATIONSHIP OF LOCAL INDUSTRIES TO NATIONAL EARNINGS

Industries with highest concentration (LQ's) in the Buffalo MSA. ¹	For each one percent change in total earnings in the United States the following local changes have occurred historically ²	Level of Confidence ³
INDUSTRY:		
Miscellaneous manufacturing industries	1.28	low
Fabricated metal products	1.60	high
Rubber and misc. plastics products	.931	high
Stone, clay, and glass products	(.420)	low
Primary metal industries	1.38	low
Paper and allied products	(.028)	low
Food and kindred products	.491	high
Chemicals and allied products	.087	high
Apparel and other textile products	.839	high
Government and government enterprises	.275	low
Earnings all industries	.898	very high
<ol style="list-style-type: none"> 1. Industries with location quotients > 120% 2. Historical period between 1969 and 1998 3. low < 90% confidence high 90 to 99% confident very high > 99% confident 4. () negative or inverse relationship 		

Earnings from all sectors in the national economy, as shown by National Income, declined by .22% during the third quarter.

CONCLUSIONS

If historical patterns hold, the full effect of the economic decline in Western New York will not be felt for some years to come. There is little doubt that there will be a series of signposts along the way. As earnings and income fall locally, pressure on social service budgets will increase while revenues from cyclically sensitive revenue sources such as the sales tax, will create stress on local government budgets. Traditionally, this has led to calls for increased aid from the state. In their present circumstance, declining state income taxes, in conjunction with September 11 related expenditure increases, may impinge on the states willingness and ability to help local governments in Erie County. Local government fiscal stress will be at continuing issue in Buffalo.

NATIONAL, STATE & LOCAL BUSINESS INDICATORS

	% change				
NATIONAL INDICATORS	2000:III	2001:I	2001:II	2001:III	2000:III - 2001:III
Real GDP (billions of chained 1996\$) (1)(a)	9,260.1	9,334.5	9,341.7	9,310.4	0.5
US Personal Income (billions of \$)	8,381.5	8,640.2	8,714.6	8,771.8	4.7
	Dec-00	Oct-01	Nov-01	Dec-01	Dec-00 - Dec-01
Leading Indicators Index (1996=100) (1)(a)*	108.6	109.2	110.0	111.2	2.39
Consumer Price Index (1982-84=100) (2)	174.0	177.7	177.4	176.7	1.55
Exchange Rate Canadian/US \$ (3) (b)	66.7	62.9	63.6	62.8	-5.85
10 Year Treasury Bond Yield (%) (3) (b)	5.11	4.25	4.73	5.02	-0.09
3 Month Treasury Bill Yield (%) (3) (b)	5.73	2.01	1.75	1.69	-4.04
S&P 500 Stock Index (3) (b)	1,320.6	1,059.8	1,139.5	1,148.1	-13.04
Dow-Jones Industrial Average (3) (b)	10,786.9	9,075.1	9,851.6	10,021.5	-7.10
LABOR MARKET TRENDS (2)					
Nonag Civilian Employment					
US (1000's) (a)	132,367	131,782	131,411	131,287	-0.82
NY State (1000's) (a)	8,691.5	8,629.4	8,607.8	8,597.1	-1.09
WNY (1000's)	566.0	562.8	563.4	562.5	-0.62
Unemployment Rate (%)					
US (a)	4.0	5.4	5.6	5.8	1.80
NY State (a)	4.5	5.0	5.4	5.8	1.30
WNY	4.9	5.0	5.2	5.5	0.60
Ave. Wkly. Hours in Mfg. WNY	43.7	42.1	42.8	43.0	-1.60
Ave. Wkly. Earnings in Mfg. WNY (\$)	799.7	784.3	802.5	812.7	1.62
Ave. Wkly Hours in Mfg. US	40.4	40.5	40.3	40.7	0.74
Ave. Wkly. Earnings in Mfg. US (\$)	607.5	609.3	613.4	627.8	3.33
WNY EMPLOYMENT BY SECTOR (1000's) (2)					
Construction and Mining	20.5	23.2	21.9	20.4	-0.49
Manufacturing	86.4	82.6	83.0	82.9	-4.05
Transportation and Public Utilities	27.0	27.6	27.6	27.6	2.22
Wholesale and Retail Trade	135.7	130.6	133.1	134.4	-0.96
Finance, Insurance and Real Estate	30.5	30.8	30.8	30.7	0.66
Services	174.6	176.1	175.3	174.5	-0.06
Government	91.3	91.9	92.4	92.0	0.77

(1) US Dept. of Commerce

(a) Seasonally Adjusted

(2) US Dept. of Labor

(b) End of month data

(3) Wall Street Journal