



Connecticut Economic Outlook

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Is Connecticut Doing So Well?

A Tale of Two Economies

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Connecticut had a phenomenal first quarter of 2007, as measured by personal income, with growth of \$6.1 billion. If you believe that we will continue to enjoy such high growth, the state's economy will grow strongly and Connecticut's total employment will *finally* surpass its levels of seven and eighteen years ago. But that big surge came from financial services, a highly volatile sector, probably driven by mergers, buyouts, and leveraged financial activities. If this is a short-term "blip," then Connecticut's economy will enjoy only modest growth and employment will only sneak by its previous highs by the end of 2009. So which economy are we in?

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Understanding the performance of the national and state economy draws on the huge array of data federal agencies collect. But data change, as agencies later get more detailed and comprehensive data. So when the Bureau of Economic Analysis (BEA) significantly revised its national current and real Gross Domestic Product (GDP) and Connecticut's GDP (CGDP) for the period from 2004 forward, it changed the basics from which CCEA constructs the CT Economic Outlook. That, combined with the most dramatic growth in personal income in Connecticut in nearly two decades, leaves us wondering where we really are.

That dramatic change the latest data revealed was Connecticut personal income surging in the first quarter of 2007 a stunning \$6.1 billion increase (\$4.0 billion in constant 2000 dollars, removing the influence of inflation). More than half--\$3.5 billion—of this surge came from financial intermediation, a sector subject to significant volatility as mergers, acquisitions, and leveraged buyouts drive much of this income. The still developing sub-prime mortgage crisis and the “flight to quality” in credit markets argues that this surge may have little durability. Thus the foundation on which CCEA develops its forecasts may be shaky.

To address the shakiness of the underlying data—that is, because personal income growth plays a central role in developing CCEA's forecast of Connecticut's future output and job growth--this Connecticut Economic Outlook develops two versions. The optimistic forecast makes no adjustments to estimates of gross regional output for the first half of this year. But recognizing the anomalous nature of recent growth in personal income, with such a high proportion coming from such a volatile sector, the second, cautious forecast assumes that only half of the preliminary estimated growth from 2006Q4 in the first two quarters of 2007 is realized. The optimistic forecast risks overstating significantly the State's expected economic performance out to 2009Q4. The cautious forecast assumes the conditions of the first quarter are unsustainable (they are already deteriorating the view of most economists). But caution can lead to a significant understatement.

REVISED DATA CHANGES THE OUTLOOK

The Bureau of Economic Analysis adjusted two annual income figures down—0.21% for 2003 and 0.13% for 2005. But BEA then adjusted the income figures for 2004 upward 0.77%. The net effect was to leave the final number for 2005 about where it was. Following from these revisions, BEA's estimate of personal income in Connecticut for 2006 fell 0.08%.

But these adjustments were in current dollars. When taking inflation into account, the Bureau's adjustments to Connecticut's total output had more downside; the Bureau lowered both 2003 and 2005 results 0.19% and increased 2004 only 0.55%. Adding in the influence of a rate of inflation higher than previous recognized results in BEA figure

for Connecticut output in 2006, in constant dollars, falling 0.18% compared to its earlier estimate and 2.1% below CCEA's previous admittedly bullish forecast.

BEA's adjustments to its data for Connecticut are small relative to its adjustments to national data, data that also underpins CCEA's Outlook. Thus, the Bureau lowered national figures in current dollars for 2004 and 2005—down 0.2%—and 2006—down 0.4%. Figures measured in constant dollars also decline by 0.3%, but—oddly—the Bureau increased its measure of disposable personal income 0.6% in 2005 and 0.8% in 2006 relative to its previous releases.¹ Perhaps households were paying fewer taxes, retaining more income for their own consumption. Indeed, that seems to be the pattern emerging from the aggressive tax cuts at the federal level. Nationally, from 2001 to 2004 personal current taxes fell by \$188.2 billion as disposable personal income rose from \$7,486.8 billion to \$8,664.2 billion. This was much faster than total growth in personal income of \$8,724.1 billion to \$9,713.3 billion². Connecticut had the same experience from 2001 through 2006: personal income grew only 3.7%, but disposable income grew 4.5%.

LOOKING TWICE

CCEA builds its forecast from national and state income statistics, discussed above, and from the number of private housing permits, employment, and real average weekly manufacturing earnings. The slight quarter-to-quarter rise in residential building permits from the first to second quarter of this year, before seasonal adjustment, disguises serious issues emerging in the housing sector. Relative to the same month a year earlier, May permits were 15.1% lower and June's 21.3% lower. Moreover, unit values were also lower, so the total value of permits issued was down even more: 19.1% and 26.6% for those months. Yet, official national housing prices series have not reflected the downturn. The national figures for the value of housing are up 3.4% relative to a year earlier and the producers' price index for housing has risen 2.8%.

The weakness in residential permits—normally a leading indicator for both construction and durables—has not hit Connecticut's seasonally adjusted construction employment. To the contrary, construction employment grew from 66.9 thousand at year ago to 68.5 thousand in 2007Q2. This outcome results probably from offsetting increases in other construction—schools, universities and state-run institutions—as well as renovations, repairs, and non-residential construction. But this strength in construction employment may be fleeting; total output in the sector is down 9.3 % for the first half of 2007 compared to the same time period a year earlier and the pipeline looks weak.

Overall Connecticut's employment growth (seasonally adjusted) has been strong, growing from 1,677,000 a year ago to 1,697,000 in 2007Q2. Weekly earnings in manufacturing have also grown, year over year, reaching \$428.61 in 2007Q2, above the figure for the same quarter in 2006: \$418.34.

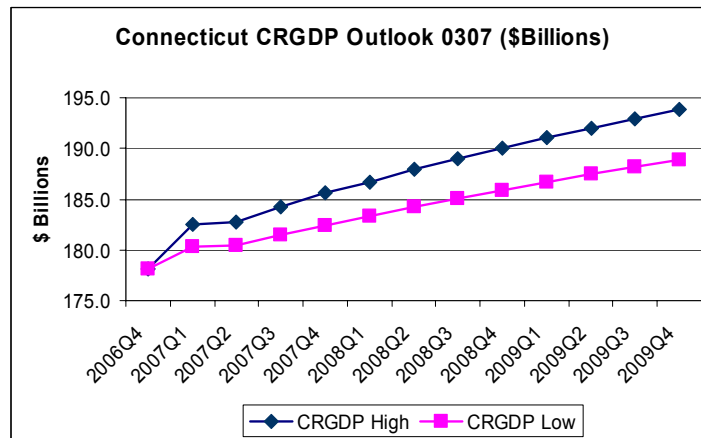
¹ BEA: News Release: Gross Domestic Product, July 27, 2007.

² http://www.bea.gov/scb/pdf/2005/11November/1105_NIPAnew.pdf

The two charts below offer both outlooks. The optimistic forecast captures the abnormally high growth in personal income, a growth we do not believe is sustainable. It is likely to overstate future growth by one to two percent. The cautious outlook adjusts for the 2007Q1 spike in the personal income series.

Chart 1 shows that, with the optimistic forecast, Connecticut RGDP continues to expand through 2009Q4, reaching \$194 billion. In contrast, growth is sufficiently slower in the lower case to limit 2009Q4 total output to \$189 billion. Growth rates for 2007 to 2009 in are 4.2, 2.5 and 2.2 percent in the optimistic case, but only 2.7, 1.9 and 1.7 when we are more cautious. In contrast, national annual RGDP growth rates in both these forecasts are for 2.1% in 2007, 3.1% in 2008, and 2.5% in 2009. Thus, even in the optimistic case, Connecticut will lose ground relative to the national economy after 2007.

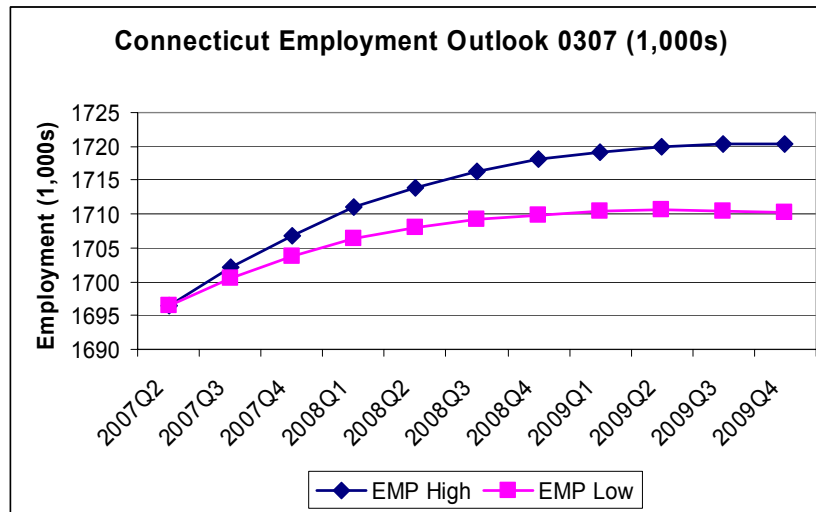
Chart 1:



Source: CCEA, August 2007.

Even though both Outlooks suggest that Connecticut employment will exceed the historical benchmark of 1.7 million in this quarter, slow growth in the cautious forecast generates weak growth in employment. Chart 2 shows that in the optimistic Outlook high case employment growth to 1,720,400 by the end of 2008. But when we are more cautious, employment growth levels out by the middle of 2009, reaching only 1,710,000.

Chart 2:



Source: CCEA, August 2007.

SECTOR EMPLOYMENT GROWTH

Similar to the two Outlook approach used above, CCEA looked at two possible outcomes for employment in aggregate by economic sector. Perhaps surprisingly, making conservative assumptions that public sector employment grows at its traditional quarterly rate (0.14%) and that employment in the private sectors change interactively as they have on average since 1990, the cautious forecast for 2009Q4 is only 362 below the 1,720,400 in the optimistic forecast. This outcome argues employment will probably grow closer to the optimistic forecast, even if the financial services sector does not sustain its income growth.

In specific sectors, the CCEA Outlook anticipates the continuing erosion of employment in manufacturing. Over the three year period 2006Q4 to 2009Q4, we anticipate the manufacturing sector losing 0.86% of its share of CT employment, while we expected services other than trade, transportation, public utilities, and finance to gain 0.44%, construction to gain 0.22%, and government to gain 0.19%. Health and education will see continued growth.

These shifts in sectoral shares reveal Connecticut's ongoing commitment to education, its aging population, and productivity growth in manufacturing. BEA's revisions and results of CCEA's Outlook for the second quarter identified growth in the value of output from durable manufacturing, growing \$1.6 billion in the first half of 2007. This growth is stronger than previously recognized, and in produced an increase in durable manufacturing employment of 936 over the same period. Non-durable manufacturing CRGDP growth over the same period was weaker at a mere \$126 million, resulting in a decline in employment of 2,153. This has been a consistent pattern in the non-durable sector for some time.

CONCLUSIONS

Despite robust growth in personal incomes and employment, Connecticut is not immune from the consequences of the national downturn in housing markets. The drop in construction CRGDP and declines in housing permits are ominous signs, though non-residential construction has to date protected the sector. Given that offset, the outlook for Connecticut remains reasonably strong, with continued growth in both CRGDP and employment. The depreciation of the dollar—making Connecticut made goods more competitive in the global market—and a lot of hard work to improve productivity may finally be being felt in durable manufacturing, but the non-durable manufacturing has yet to show indications of recovery. The main determinant of one's view of the future however depends on the longevity of the financial sector's dominant contribution to Connecticut's growth in the first quarter of 2007.