Skirting a Recession?

The Connecticut Economic Outlook: February 2008

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This CCEA Outlook sees a deteriorating state economy, one that will just skirt a formal recession as total output continues to grow at an anemic rate, but it anticipates that the state will suffer modest job loses over the next two years.

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Overview: *Skirting a Recession*

Anemic Growth; Flat or Falling Employment

The American economy is slowing more rapidly than most economists had predicted, as the corrosive impact of the sub-prime mortgage crisis—now projected as a $400 *billion* loss—and the collapsing confidence in financial markets infects other elements of the national and global economies. Michigan is already suffering a serious recession, and California, Florida, and Ohio may have now slipped into the red. This CCEA Outlook anticipates that Connecticut will skirt a formal recession, seeing anemic growth in output—averaging a meager 1.8% over two years—but will see significant and growing job loses in manufacturing and more modest loses in construction and government. Modest but slowing job creation in services, financial services, trade, and other sectors will fail to offset these loses; over the next two years this Outlook forecasts Connecticut losing 7,000 jobs.

Pieces of the Pie: Employment and Output

This CCEA Outlook sees CT employment growing 0.4% in 2008, but then declining 0.3% in 2009. This will result, over the two years, in a loss of 7,000 jobs, from total employment of 1,704,000 in 2007Q4 to 1,697,000 in 2009Q4. The previous forecast had seen a rise to 1,713,000 by the end of 2009, so the current turmoil will cut 17,000 jobs from potential.

Chart 1 below shows the employment trend line and Chart 2 the outlook for employment growth by sector:

Chart 1:

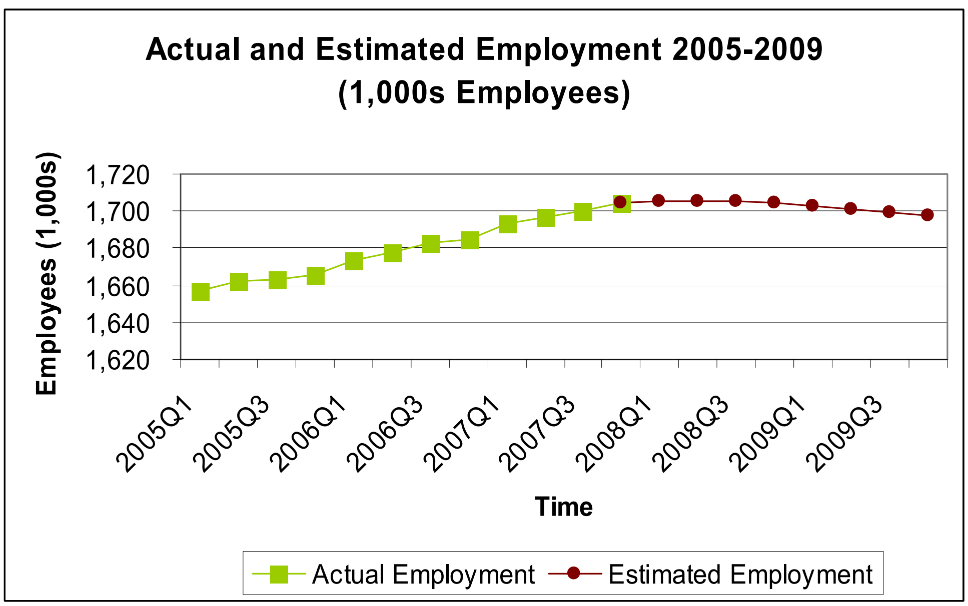
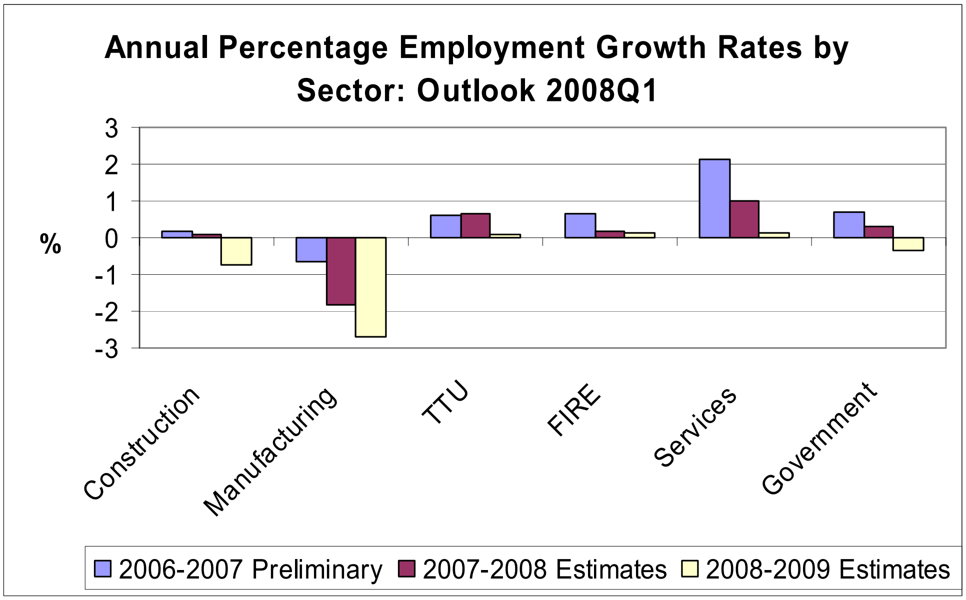
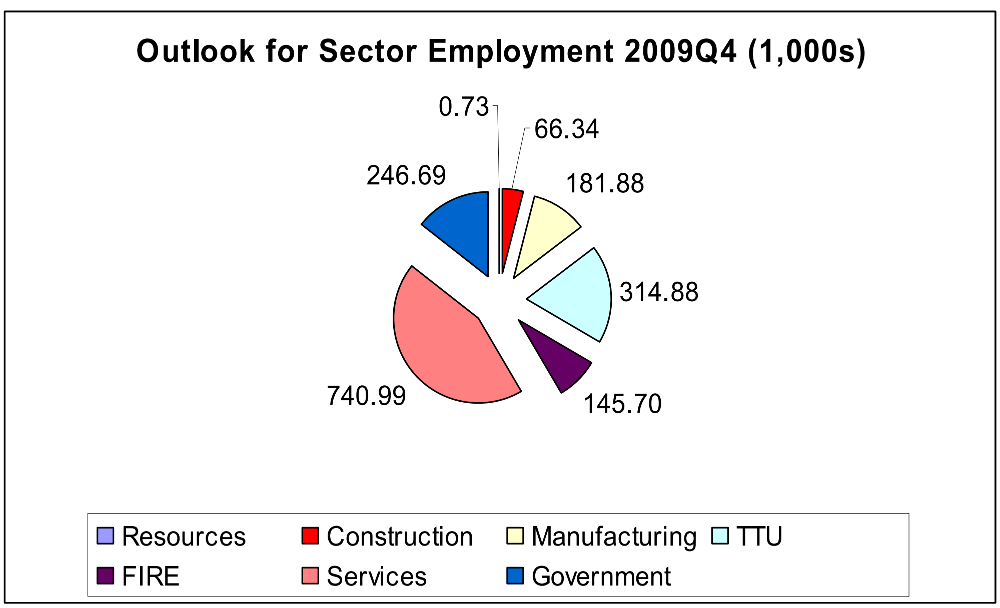


Chart 2:



Aside from services and manufacturing, the sector employment outlook anticipates annual changes of less than one percent. Growth rates in Transportation, Trade and Public Utilities, Finance Insurance and Real Estate remain small but positive throughout. Growth rates in both Construction and Government remain barely positive in 2007 and 2008 but turn negative in 2009. The Service sector generates the only significant employment growth, expanding at 2.1, 1.0 and 0.11 percent. In contrast, Manufacturing employment declines, particularly in non-durables, over the entire period. The net result is a modest loss of jobs. Chart 3 shows the expected composition of CT employment for 2009Q4.

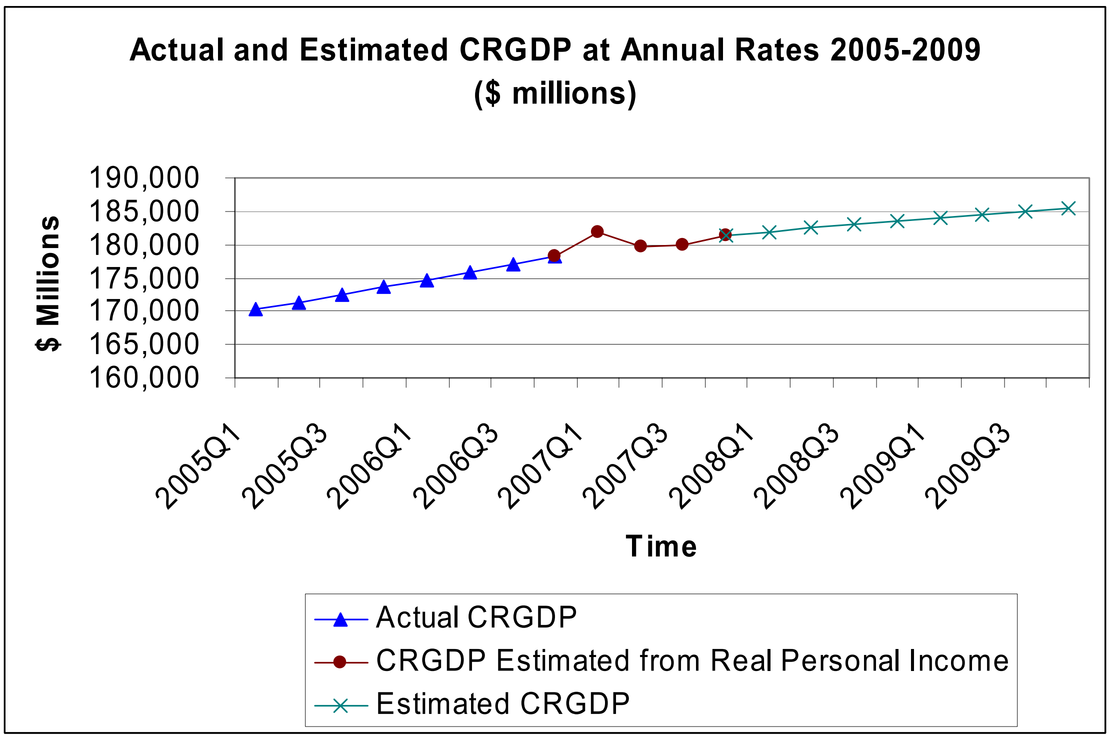
Chart 3:



Consistent with employment growth too small to absorb new entrants to the labor force, the Outlook sees real manufacturing earnings (RME) falling. Preliminary data for 2007Q4 already suggests this decline has begun, coming in at $428 per week rather than the forecast of $435. Both recent CCEA Outlooks foresee further declines in RME of another $7 out to 2009Q4.

In addition, bonuses in financial services gave a $4 billion blip in CT real personal income at the beginning of 2007, generating an estimated $4.6 billion spike in Connecticut's economy in that quarter, shown in Chart 4. Smoothed out over the year, these bonuses generated a significant 2.5 percent in estimated 2007 state output. Reductions in bonuses—reflecting both the market turmoil at the end of 2007 and the absolute necessity of building reserves to offset the sudden emergence of significant risks—will increase downward pressures on Connecticut's output in the coming months.

Chart 4:



These developments point to slower expected Connecticut's growth rates in 2008 and 2009. They remain positive due to on-going productivity gains, but growth for 2007 slowed significantly, and the forecast for 2008 and 2009 have dropped to 2.2% and 1.5%. Given a lowering of real manufacturing weekly earnings, lower expected bonuses, and erosion of employment gains after the second quarter of this year, this Outlook's expected growth rate in 2008 is about half that projected in the previous forecast. The Connecticut economy will reach $182 billion by the end of 2007, and continue its modest growth through 2009, rising to $185 billion. This falls $4 billion below previous forecasts. This continuing estimated positive but very sluggish growth of national growth and estimated Connecticut output through 2008 and 2009 argues that we will skirt, rather than falling into, a formal recession. But Connecticut will see no job creation, and very likely job losses.

A Comment on the Role of Government

The reversal of rising government employment in this Outlook is striking. A traditional response by government to staving off recession would lead to increased government spending and employment. Yet, the nature of this economic situation suggests that governments are going to experience significant tightening fiscal capacity. According to the Center on Budget and Policy Priorities (CBPP), 20 States have already announced budget gaps totaling more than $34 billion, another seven expect gaps that are as yet not quantified[1]. Connecticut has informed CBPP that it expects a deficit for fiscal 2009, but has not released information on its expected size[2].

Historically, the following constraints to government economic recovery actions have come into play:

1. The 2001 recession resulted in sharp declines in state revenues that led to spending and staff reductions;
2. Capital gains now constitute a larger share of adjusted gross income, tying fiscal capacity more tightly to stock market gyrations;
3. The Rockefeller Institute's most recent State Revenue Report revealed state tax revenue declined in the 2007Q3 by 0.6% after adjusting for inflation and tax-law changes[3]; and
4. The curtailment of bonuses awarded senior executives is expected to measurably impact Connecticut personal income and thus income tax collections.

Pieces of the Pie: Construction Permits

Unit housing permits declined more precipitously than expected a quarter ago, falling in 2007 by 20.9% rather than the expected drop of 17.8%. Compared to 2007 quarterly averages of 1865, Q4 permits sunk to new lows at 1,583 permits. Given the depth of the sub-prime malaise, this Outlook now expects annual residential unit permits to fall another 13.0% in 2008 relative to 2007, rather than the modest 2.1% for which the previous forecast looked. Recent interest rate cuts by the Federal Reserve may mitigate this contraction, and regulatory intervention may slow the flood of foreclosures sweeping some parts of the country. The combination of lower interest rates and reductions in foreclosures leave some possible upside to this current outlook for permits and housing construction. The one hopeful outcome from the sharper short downturn in permits in this Outlook is a return to very modest growth in 2009, rather than a continuing decline seen in the previous Outlook. By 2009Q4, they are expected to begin to recover to a quarterly average of 1653 units, still over a thousand below norms over the last decade. See Chart 5.

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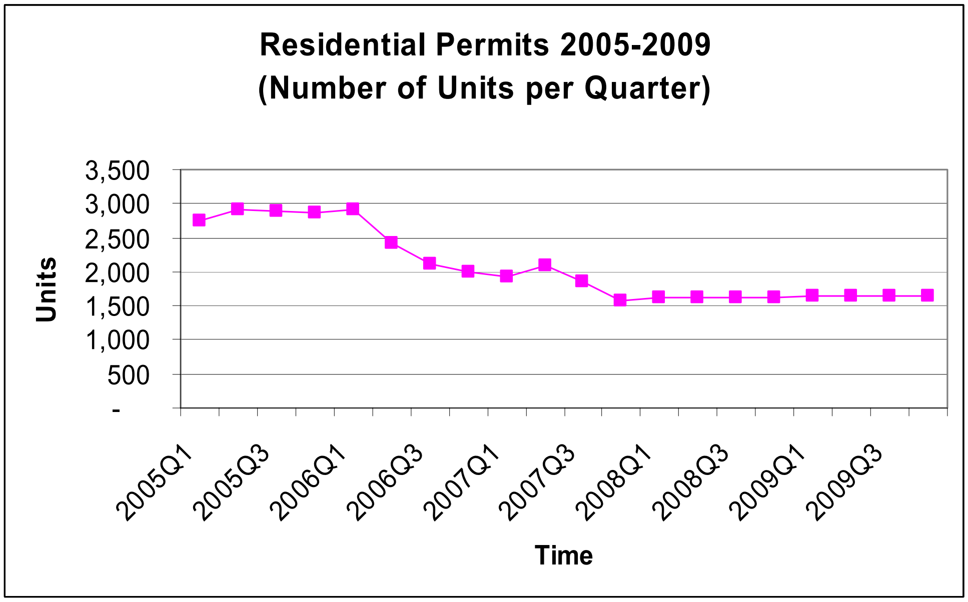
[1] http://www.cbpp.org/1-15-08sfp.htm
[2] http://www.cbpp.org/1-15-08sfp.htm
[3] Donald J. Boyd assisted by Lucy Dadayan, *What Will Happen to State Government Finances in a Recession*, The Rockefeller Institute Fiscal Report, Jan. 30,2008.

Chart 5:



Robust non-residential building and $19,000 in increased average values of residential permits in 2007 over a year earlier sustained construction employment, which rose 1,500 in 2007, as the previous Outlook anticipated. Despite the malaise in residential construction, this Outlook sees employment in construction remaining flat in 2008, before declining by only .75% in 2009. This view may be optimistic because it presumes that strength in non-residential will continue to offset weakness in the residential sector.

For additional comments or clarifications, please contact:
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