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Long Island's Economic Outlook:

THE EFFECT OF NATIONAL BUSINESS CONDITIONS

Long Island's economic recovery has not kept pace with the nation's economic recovery in recent years. In part, this reflects the fact that Long Island has a mature economy in which job growth in many areas has "caught up" with previous population growth. Today, the U.S. economy is slowing and the slowdown is expected to last well into 2007. This means that Long Island will face even stronger economic headwinds in coming months. This article examines the national economic forces that are likely to impact Long Island's economic growth during 2007 and discusses Long Island's current economic strengths and weaknesses.

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The National Economy

In a two-year period, the Federal Reserve raised short-term interest rates from a low to 1.0 percent to a high of 5.25 percent in order to slow the U.S. economy from its torrid growth pace. As a result, U.S. GDP growth slipped from 5.6 percent in the first quarter of 2006 to only 2.0 percent by the third quarter. The Fed has held short-term rates steady at 5.25 percent since August 8th in the belief that it has succeeded in taming inflation, thereby putting the economy on the path to a "soft landing". Recent indicators confirm that the Fed may in fact have succeeded in moderating inflation without tipping the economy into another recession.

U.S. job growth remains strong despite today's higher interest rates. The number of jobs created during 2006, about 149,000 monthly, was close to the monthly figure of 165,000 during 2005. The nation's November 2006 unemployment rate, 4.5 percent, was at a five-year low. Moreover, hourly wages are finally rising faster than inflation. As a result, the purchasing power of U.S. workers is growing at a pace reminiscent of income growth during the economic boom of the late 1990s.

Consumer inflation has also moderated due to falling energy prices. Consumer prices were unchanged in November after declining by 0.5 percent in both September and October. Consumer prices are currently rising at an annual rate of 2.2 percent, down from a rate of 3.4 percent during 2005. Core consumer inflation, which excludes price changes for food and energy, was also unchanged in November but was higher in 2006 than in 2005.

Gains in real wages coupled with declining gasoline prices left households with more money to spend as they approached the critical holiday shopping season. As a result, holiday sales began on a strong note. November retail sales rose by 1.0 percent, the best showing since a 1.4 percent gain in July. This was welcome news to retailers who had suffered through several months of lackluster sales when surging gasoline prices led to a consumer pullback. Electronics retailers did particularly well during the holiday season but furniture sales declined in response to the slowing housing market.

The housing market has been hard hit by higher interest rates. However, while home sales and residential construction have fallen, the housing market is not in free fall. Late mortgage payments have been increasing, with sub-prime buyers experiencing the highest delinquency rates. According to the Mortgage Bankers Association, the delinquency rate for sub-prime borrowers was 12.56 percent in the third quarter of 2006. The delinquency rate for sub-prime borrowers with adjustable-rate mortgages was even higher, 13.22 percent. Builders continue to be pessimistic as they work through their bloated inventories. However, most analysts believe that the worst of the housing slump will be over by the middle of this year.

The manufacturing sector is also ailing. Industrial production is flat and manufacturers have idled 95,000 workers since June. Moreover, recent declines in new orders suggest that factory output will not strengthen much in the foreseeable future. The nation's trade deficit also remains a drag on the economy. It is currently running at an annual rate of $772.1 billion, a new high. Much of America's growing trade deficit reflects its worsening trade imbalance with China. America's trade deficit with China is currently running at an annual rate of $229 billion, 13 percent above its 2005 level. The recent weakness in the U.S. dollar vis-à-vis foreign currencies reflects a growing unease about America's large trade and budget deficits in global capital markets.

The U.S. economy is likely to grow at a sub-par rate well into 2007. However, another recession does not appear imminent at this time. Barring another spike in oil prices, inflation should remain contained. Moreover, the housing bubble appears to be deflating slowly rather than bursting. There also seems to be enough strength in other sectors of the economy to take up some of the slack created by the weakening housing market. Relatively low unemployment and rising real wages mean that consumers should have adequate income for discretionary spending. U.S. corporations are flush with cash stemming from their above-average profits over the past several years. The lower dollar coupled with faster economic growth abroad should increase demand for U.S. exports. Therefore, by raising interest rates, the Federal Reserve may have prolonged the current economic expansion, which by historical standards is already "long in the tooth".

The actual pace of U.S. economic growth during 2007 will depend on the strength of consumer and business spending. Many of the same factors that spurred business capital spending in 2006 will also be operational in 2007. Many businesses are still playing catch-up in terms of capital spending following several lean investment years. Although profit growth is expected to slip into the single digit range this year, worker productivity has not declined as much as in other recent business cycles and most businesses should still have enough internally generated cash to finance future capital expenditures. If not, the capital markets will continue to offer relatively low-cost financing opportunities during 2007.

Continued gains in income and wealth should support a moderate level of consumer spending in 2007. However, with the rate of income growth likely to diminish, consumer spending may ease off from its 2006 annual rate of 3.0 percent. There is also the possibility that declining home prices may yet have a negative impact on consumer spending, as would any increase in unemployment caused by the slowing economy. There are some indications that the housing decline is bottoming out. For example, U.S. housing starts rose by 6.7 percent between October and November. If the housing market is beginning to stabilize, housing may be less of a drag on the economy than had been anticipated.

The Federal Reserve is likely to keep interest rates unchanged for the foreseeable future. In fact, there is some disagreement as to whether the Fed's next interest rate move will be up or down. There is no certainty that inflation has been fully tamed. The Fed voiced continued concern about inflation at its December meeting. Subsequent developments seem to have justified that concern. Oil prices climbed above $63 a barrel in mid-December and OPEC, the Organization of Petroleum Exporting Countries, plans to cut output by half a million barrels a day in February. Given the resilient consumer demand for oil, this could lead to another energy price spike. Rising energy prices caused November's producer price index, a measure of wholesale price movements, to rise by 2 percent, the biggest monthly increase since 1974. Renewed inflation could cause the Fed to raise interest rates once again.

Conversely, the economy could begin to slow too much, forcing the Fed to lower interest rates to avert a recession. If the housing decline worsens or spills into

Inflation Rates vs. Changes in Long Island Sales Tax Revenues, 2006

Month	Inflation Rate (%)	% Change in Sales Tax Revenues From Previous Year
January	3.7	5.8
February	3.6	7.9
March	2.7	5.3
April	3.6	2.6
May	4.8	-0.6
June	5.6	0.2
July	5.0	-0.8
August	4.7	1.6
September	3.3	-0.5
October	2.4	7.3
November	2.6	2.9

Sources: U.S. Bureau of Labor Statistics; New York State Department of Taxation & Finance other sectors of the economy, lower interest rates could be needed by mid-year. One such scenario is that the housing decline will negatively affect consumer spending and indirectly cause a drop in business capital spending. At present, however, the possibility of a "goldilocks" economy that is growing slow enough to keep inflation under control but not slow enough to cause another recession, should keep the Federal Reserve on the sidelines for some months.

Non-Farm Payroll Employment in Nassau & Suffolk Counties

Industry	Number of Jobs, Nov. 2006	Net Change, Nov. 2005-06
Manufacturing	85,900	-1,800
Construction	69,300	200
Wholesale Trade	71,400	-600
Retail Trade	167,000	-1,100
Transportation, Warehousing, Utilities	37,800	-800
Information	29,500	-100
Financial Activities	81,200	-900
Professional & Business Services	164,500	3,400
Educational & Health Services	205,700	1,300
Leisure & Hospitality	94,600	1,300
Other Services	53,000	400
Government	203,300	200
Total	**1,263,200**	**1,500**

Source: New York State Labor Department

The Long Island Economy

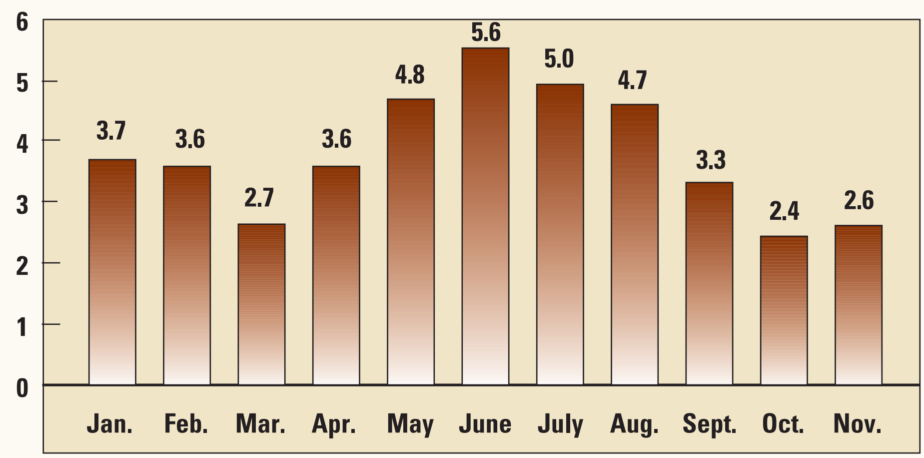
Long Island is continuing to experience extremely slow job growth and weakening home prices. However, moderating inflation is providing some support for consumer spending and to date, the home price decline has been confined to Nassau County and has been relatively gradual.

The Housing Market. Five consecutive years of double-digit home price increases on Long Island have ended. The November median price of newly sold Nassau County homes was $465,000, down 5.1 percent from median prices in November 2005. The comparable Suffolk median was $395,000, an increase of 1.3 percent from year-ago levels.

These figures suggest that Long Island's housing market is far from imploding and that any future price declines will be moderate. If history is any guide, these declines will occur over a three-to-five year period and will be uneven across communities. Long Island is still experiencing relatively strong demand for housing from newly formed households and recent immigrants. That demand is bumping up against a relatively fixed supply of housing and a diminishing supply of raw land. The tight housing market should put a floor under home prices, thereby preventing significant price declines. On average, Long Island home prices could decline by 10 to 15 percent before bottoming out, with the steepest declines occurring at the high end of the market where sellers have more leeway to reduce prices. Given the fact that Long Island home prices doubled in the past five years, a price decline of this magnitude is unlikely to make housing significantly more affordable for most Long Island households

The Consumer Sector. Long Island's robust housing market during the first half of this decade provided strong support for consumer

Monthly Inflation Rates in the New York Region, 2006 (percents)



spending. Rising home prices made consumers feel wealthier and more inclined to spend. In addition, some households extracted equity from their homes in order to finance their current expenditures. Today's higher interest rates coupled with flat to declining home prices have eliminating this source of spending cash for most households. They must instead rely on their current incomes to support their spending.

Long Island's softer housing market does not appear to have materially affected the pace of consumer spending. However, the spike in gasoline prices did cause a consumer pullback in the middle of last year. Data concerning Long Island's sales tax receipts showed that consumers clearly reduced their discretionary expenditures when gasoline prices exceeded $3 a gallon and the region's inflation rate peaked at 5.0 percent or more in June and July. By contrast, the dramatic reduction in gasoline prices and inflation between September and November caused a rebound in sales tax revenues, indicating that consumers had again returned to the shopping malls.

The Labor Market. Whereas Long Island's consumer and housing sectors are heavily influenced by macroeconomic factors such as U.S. inflation and interest rates, the local labor market situation more closely reflects current labor supply and demand conditions on Long Island.

Nassau and Suffolk Counties currently have extremely low unemployment rates despite the fact that employment growth has been minimal. The Nassau-Suffolk labor market generated only 1,500 non-farm jobs in the twelve months ending in November. Moreover, half of its major industries experienced job losses during this period. Nevertheless, the November unemployment rate was only 3.4 percent in Nassau County and 3.5 percent in Suffolk County, well within the definition of a full-employment economy.

This apparent contradiction reflects the fact that Long Island's sluggish job growth is more a function of labor force shortages than of an absence of new jobs. Anecdotal evidence suggests that Long Island employers cannot find workers with appropriate skills to fill available jobs. The current worker shortage reflects a combination of factors. To some extent, there is a structural mismatch between the skills supplied by job seekers and the skills needed by local employers. The remedy is to ensure that current and potential workers receive appropriate training for the types of jobs being created. A more intractable problem is the fact that many young people are starting their careers elsewhere because they cannot afford Long Island's pricey housing or property taxes. Although some solutions to these problems have been proposed or implemented, there is no quick fix to this situation.

Long Island's Economic Outlook. As long as Long Island continues to have a relatively full-employment economy and barring any new spike in energy prices, there should be enough momentum in the economy to avoid another recession in 2007. However, significant imbalances in Long Island's housing and labor markets have increased the fragility of the Long Island economy. As a result, the economy has become more vulnerable to outside shocks such as another spike in energy prices, another hike in interest rates or a worsening housing slump. The most likely outcome for 2007 is that the Long Island economy will amble along at a relatively slow pace. However, there is considerable downside risk to this forecast.

Year-to-Year Percent Change in Long Island Sales Tax Revenues, by Month, 2006