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THE FEDERAL RESERVE REDUCES INTEREST RATES: ITS IMPACT ON THE LONG ISLAND ECONOMY

The Federal Reserve responded to growing concerns about an economic slowdown by lowering both short-term interest rates and its discount rate for loans to member banks. The moves were intended to inject liquidity into the economy, calm jittery credit markets, spur consumer spending and encourage business investment. Lower interest rates could be particularly helpful to Long Island, where home foreclosures have been rising and consumer spending has slowed. This article discusses how changing national business conditions are likely to affect Long Island employment, consumer spending and housing activity.

BY DR. PEARL M. KAMER,
LIA Chief Economist

The National Economy

Although the U.S. economy grew at a robust annual rate of 4 percent in the second quarter of this year, economic growth slowed significantly thereafter. Turbulence in U.S. stock and credit markets during August dented consumer confidence and greatly increased borrowing costs for both consumers and businesses. As credit markets seized up, even creditworthy borrowers were hurt. At the same time, foreclosure filings surged as some of the subprime mortgage loans issued in 2005 and 2006 reset to higher interest rates and borrowers began to default on their loans. Deteriorating credit market conditions coupled with the loss of 4,000 payroll jobs between July and August, the first such job loss in four years, caused the Fed to act. At its September meeting it reduced its benchmark interest rate from 5.25 percent to 4.75 percent and also lowered its discount rate by half a percent. With the credit crisis spilling over into the general economy, the growing risk of recession could no longer be ignored.

The Fed's unusually large interest rate reduction was designed restore confidence in credit markets and in the economy. The move appears to have had some initial success. The stock market immediately rallied and several large banks reduced their prime lending rates. However, there are significant downside risks to the Fed's aggressive move. Not only could it be viewed as a bailout of those who contributed to the housing bubble, but it is also likely to fuel future inflation because it comes at a time when industrial capacity is tight and unemployment remains low. Moreover, lowering interest rates when the dollar is declining relative to foreign currencies will speed the dollar's decline and increase the price of imports. Thus, the U.S. could "import" inflation. Inflation concerns recently sent gold to a 27-year high of more than $732 an ounce. For now, however, inflation appears to be contained. August consumer prices fell for

Table 1

The Growth of Payroll Jobs on Long Island, August 2006-07

Industry	**Employment, Aug. 2007**	**Net Change, Aug. 2006-07**
Manufacturing	84,300	-1,300
Construction	74,200	1,700
Wholesale Trade	74,600	1,300
Retail Trade	163,500	1,500
Transportation, Warehousing, Utilities	32,100	-700
Information	30,200	0
Financial Activities	78,000	-2,700
Professional & Business Services	168,900	3,000
Educational & Health Services	201,300	2,100
Leisure & Hospitality	110,200	2,100
Other Services	52,400	700
Government	185,400	1,400
Total Non-Farm Employment	**1,255,100**	**9,100**

Source: New York State Labor Department

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Table 2

Residential Foreclosures in Nassau-Suffolk, First Half of 2007			
County	Number of Foreclosures	Percent Change From Prior Year	Ratio Per Number of Households
Nassau	1,822	-21%	1 per 251 households
Suffolk	2,993	+65%	1 per 180 households

Source: RealtyTrac

the first time in 10 months due to a decline in energy costs. Nevertheless, with crude oil prices currently above $80 a barrel, energy price declines could easily be reversed.

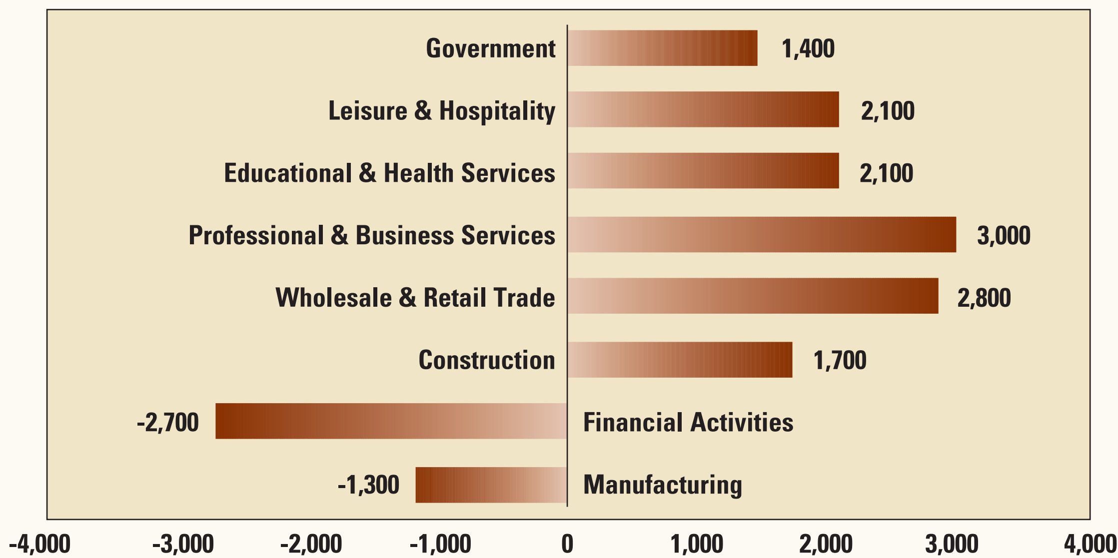
Economists remain concerned that lower interest rates may not cure today's economic problems, which include tight credit markets and widespread mortgage defaults, because lower rates will not calm fears about credit quality. Lenders know that there are weak assets out there, but they don't know who holds them or how great the risk actually is. Until these concerns are adequately addressed, credit markets could remain unusually tight despite the Fed's recent interest rate moves.

Tight credit markets would intensify the current housing crisis. The housing market is continuing to weaken. Construction of new homes fell by 2.6 percent in August to the slowest pace in 12 years. The National Association of Home Builders' index of builder confidence fell to its lowest level on record in September. Housing and housing-related industries were responsible for much of the nation's economic rebound from the 2001 recession. They generated more than 788,000 jobs between November 2001 and April 2005 and accounted for 40 percent of total U.S. job growth during this period. Housing and housing-related industries have since become a significant drag on the economy. Some 120,000 housing-related jobs were lost since August 2006.

The housing crisis originated in the market for subprime mortgages, those given to homebuyers with weak credit histories. Subprime mortgages, a relatively new phenomenon, often involve high loan-to-value ratios, a lack of income documentation and low initial "teaser" interest rates that subsequently reset to much higher rates. Approximately $370 billion in adjustable-rate mortgages will reset this year, $50 billion in October alone. These resets will affect an estimated two million households whose monthly payments could double or in some cases even triple. Sharply higher monthly mortgage payments have already caused a wave of mortgage delinquencies and home foreclosures. Foreclosure filings in August were 115 percent above their level of a year ago. By some estimates, one in every 62 households could be in foreclosure this year, a rate not seen since the Great Depression.

The credit crunch is now affecting more traditional home loans and the market for commercial paper. Sales of higher-priced homes have declined sharply because high-end buyers can no longer obtain jumbo mortgages, defined as loans of more than $417,000. Such loans are too large to be guaranteed by one of the government-sponsored housing finance agencies, Fannie Mae, Freddie Mac or Ginnie Mae, and investors are shunning loans without such guarantees. Lenders making such loans have raised their interest rates to large borrowers to compensate for the added risk of keeping these loans on their own books.

The Federal Reserve acted to prevent the current financial crisis from becoming a full-blown economic crisis. One of the Fed's concerns was that higher borrowing costs would lead to a consumer pullback. Consumer spending, which accounts for two-thirds of economic activity in this country, had already weakened by the time the Fed acted. Although there was a modest 0.3 percent increase in retail sales between July and August, the increase reflected a 2.8 percent surge in auto sales as dealers discounted their 2007 models. Non-auto retail sales actually



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declined by 0.4 percent, which was the poorest showing in almost a year. The consumer pullback reflected a significant decline in consumer confidence. The Conference Board's consumer confidence index declined from 111.9 to 105.0 between July and August. The Fed was also concerned that a consumer pullback would negatively affect business spending because businesses are reluctant to "spend into a recession". The lower interest rates resulting from the Fed's recent interest rate moves will reduce borrowing costs for millions of households and businesses. It also signals the Fed's willingness to use all of the tools in its arsenal to prevent a full-blown recession.

The U.S. Economic Outlook

The Congressional Budget Office projects U.S. economic growth of 2.1 percent this year but some analysts expect even slower growth. Slower growth could push the nation's unemployment rate, currently at 4.6 percent, to 5.0 percent by yearend. Analysts differ about the housing outlook and its future impact on the economy. Some believe that the plunge in home prices will not be as severe as in the early 1990s. They note that the average American earns 7 percent more today than in 2005, when the housing market peaked. Moreover, the economy has added four million new jobs since 2005. These optimists believe that once lenders recognize that most homebuyers can in fact repay their mortgage loans, credit markets will begin to stabilize. Lower interest rates should help this process along. A more pessimistic view is that the combination of a growing inventory of homes for sale and tighter mortgage lending standards will continue to put downward pressure on home prices, leading to more mortgage delinquencies and foreclosures. In this view, a plummeting housing market will eventually lead to recession despite the Federal Reserve's recent interest rate moves.

The housing market will clearly be a major influence on U.S. economic activity for the foreseeable future. However, the weakness in housing will be offset to some extent by strength in manufacturing and by increased exports. Manufacturing output is expanding at a brisk pace, driven by the production of business equipment and high-technology goods. Much of this output is destined for foreign markets. The growing global economy has increased the demand for U.S. exports and the weakening dollar will continue to make U.S. exports more competitive abroad. Growing foreign demand for U.S. manufactured goods should ensure a continued rebound in manufacturing. Recent good news concerning wages and inflation coupled with lower interest rates should also help to support consumer spending. Average weekly wages, adjusted for inflation, increased by 0.5 percent in August, the biggest increase since last October. Gains in purchasing power come just in time for the upcoming holiday season. The National Retail Federation expects consumer spending to increase by about 4 percent during November and December, only slightly below the 4.6 percent gain during last year's holiday season.

The Long Island Economy

Regardless of how the current housing and credit market crises play out, the U.S. economy is likely to begin 2008 with significantly less momentum than it currently has. However, lower interest rates could be particularly beneficial to the Long Island economy, much of which is based on consumer spending and housing market activity.

The Job Market

Long Island still has a full-employment economy. Its August unemployment rate was only 3.9 percent as compared with rates of 5.8 percent in New York City and 4.6 percent in New York State. Nassau and Suffolk Counties gained only 9,100 payroll jobs in the twelve months ending in August, well below the historical average of between 12,000 and 15,000 jobs annually. (See Table 1) This was equivalent to an August growth rate of 0.7 percent as compared with a 1.5 percent rate of job growth in neighboring New York City. Long Island's job growth has been concentrated in professional and business services, educational and health services and in the leisure and hospitality industry. Job losses occurred principally in finance and manufacturing. The loss of 2,700 finance jobs in the past year reflects the bankruptcy of a major Long Island mortgage lender.

The Housing Market

Long Island's economy was driven principally by its robust housing market during the first half of this decade. Five consecutive years of double-digit home price increases created a housing bubble that began to deflate during the latter part of 2006. Because home prices had become so out-of-line with the ability-to-pay of

Table 3

The Median Price of Newly-Sold Homes, 2007

Month	Nassau	% Change, 2006-07	Suffolk	% Change, 2006-07
January	$450,000	-6.2	$397,500	1.9
February	460,000	-8.0	379,000	-1.0
March	470,000	0.0	394,000	-0.7
April	473,800	0.8	400,000	3.9
May	494,000	3.2	392,800	-0.6
June	485,000	-3.0	420,000	2.3
July	495,000	1.0	405,000	-1.2
August	502,500	1.5	409,900	-1.2

Source: Multiple Listing Service of Long Island

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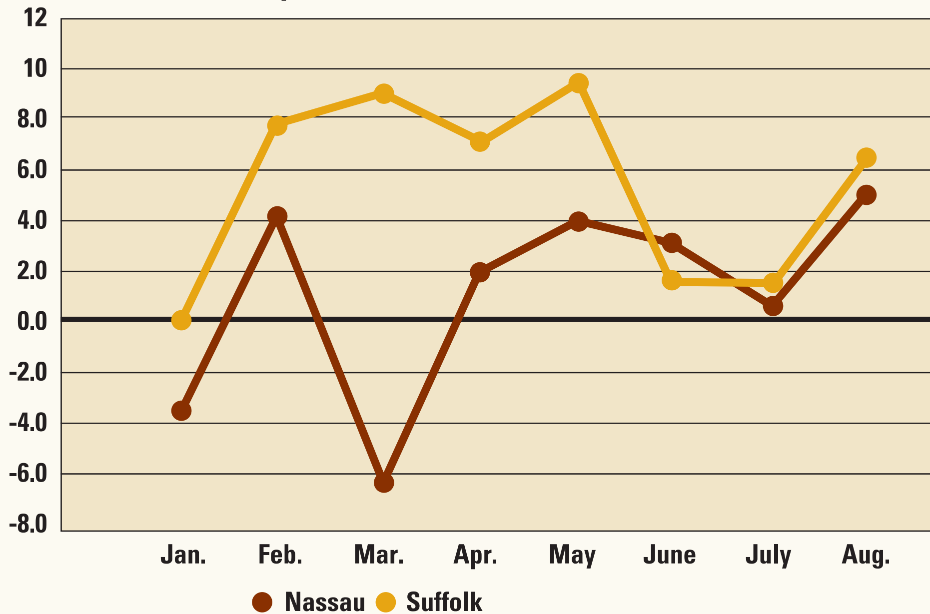

potential homebuyers, subprime mortgage loans became commonplace among recent purchasers. These loans are now resetting to higher interest rates, leading to a wave of delinquencies and foreclosures, particularly in Suffolk County. There were 2,993 foreclosure notices in Suffolk County in the first half of this year, an increase of 65 percent over foreclosures in the first half of 2006. This is equivalent to one foreclosure for every 180 properties. Some 1,822 properties were in foreclosure in Nassau in the first half of this year, a decline of 21 percent when compared with the first half of 2006. This is equivalent to one foreclosure for every 251 properties. (See Table 2) By comparison, the national foreclosure rate is one for every 216 properties. Suffolk's higher foreclosure rate may reflect the fact that it has more first-time buyers than Nassau. First-time buyers are more likely to extend themselves financially in order to purchase a home. Suffolk's median household income is also slightly lower than that of Nassau, $76,847 versus $85,994 as of 2006.

As yet, overall Long Island home prices have not dropped significantly. The August median price of newly sold homes was $502,500 in Nassau and $409,900 in Suffolk. This was equivalent to an annual increase of 1.5 percent in Nassau and a decline of 1.2 percent in Suffolk. (See Table 3) Home prices could decline more steeply in coming months as more homes are offered for sale and fewer potential buyers qualify for mortgages. The most significant price declines are likely to occur at the high end of the market, where sellers have more leeway to lower prices. There are preliminary indications that this is already happening.

The Consumer Sector

Consumer spending, as indicated by trends in sales tax revenues, has fluctuated widely from month-to-month on Long Island. In the first eight months of this year, year-to-year sales tax increases averaged 1.2 percent in Nassau and 5.3 percent in Suffolk. August sales tax revenues were somewhat stronger than in recent months, possibly because local retailers discounted their summer merchandise to make room for new fall offerings. (See Table 4)

Long Island's Economic Outlook

Barring a significant deterioration in U.S. business conditions, the Long Island economy should continue to grow at or close to its present pace in coming months. Long Island's tight labor market is likely to result in steeper wage increases as businesses compete for scarce labor. Wage gains and lower borrowing costs stemming from the Fed's recent interest rate moves should put a floor under consumer spending and ensure at least a moderate level of consumer spending during the crucial upcoming holiday season. The housing market adjustment is likely to require two or three years to run its course. Although mortgage rates are not expected to decline significantly from their current levels, the Fed's move may prevent a further escalation of rates. This means that some at-risk Long Island homeowners may be able to renegotiate or refinance their adjustable-rate mortgages so as to make them more affordable and avoid foreclosure. By avoiding unnecessary foreclosures, it might be possible to stabilize Long Island's housing market more quickly.

Table 4

Recent Trends in Sales Tax Revenues (Percent Change from Previous Year)

2007	Nassau	Suffolk	Nassau-Suffolk
January	-3.2	-0.1	-1.6
February	4.2	7.2	5.8
March	-6.3	9.0	1.3
April	2.1	7.0	4.7
May	4.1	9.3	6.8
June	3.1	1.7	2.4
July	0.5	1.3	1.0
August	5.2	6.7	6.0
Average Increase, Jan.-Aug.	**1.2**	**5.3**	**3.3**

Source: New York State Department of Taxation & Finance

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