Outperforming the Nation: Can It Be Sustained?

The Connecticut Economic Outlook: November 2011

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This CCEA Outlook explores state policies for sustaining recovery and prospects of Connecticut outpacing the Nation.

Executive Summary:

Preliminary indications are that Connecticut Real Gross Domestic Product (CTRGDP) growth in 2011 is outperforming the national pace. Will Connecticut be able to sustain that superior performance? Universally forecasters have been rushing to downgrade their 2011 projections for the American economy. These revisions bring most in line with CCEA's previous national forecast-- CCEA continues to expect that America's 2011 national growth rate to be 1.85%. Connecticut will enjoy relatively robust growth of 2.64% for 2011, sufficient to raise total Connecticut employment by 6,000 in the fourth quarter of 2011 compared to the last quarter of 2010.

After beating the national rate in 2011, CCEA sees CTRGDP slowing over the next eight quarters, returning to the historical pattern in which the Connecticut growth rate lags America's national rate. In its base case forecast, CCEA anticipates national RGDP growth year-over-year (YoY) for 2012 of 2.6%, while Connecticut's YoY growth dwindles to 0.7%. But while CCEA's base case outlook is unduly pessimistic; it does not take into account the economic impact that policy commitments to major infrastructure investments will have.

Despite being in the early stages of construction and recruiting for (1) the emerging biosciences complex, Biosciences Connecticut, (2) other aspects of UConn's School of Medicine and Dentistry expansion, and (3) creation of the Farmington campus of Jackson Laboratories, these projects can boost CTRGDP growth markedly, to 0.9 % in to 2012 and to 1.15% in 2013. These initiatives alone will add another 7,000 direct, indirect, and induced jobs to the already expected job creation of 11,000 over the eight quarters from September, 2011 to September, 2013. Further building on this emerging cluster and the acceleration of other major projects such as the New Britain-Hartford Busway will generate additional stimulus. In aggregate, north central Connecticut will see major construction projects increasing from $137.5 million in 2010 to $232.5 million in 2011. Current commitments reach $459.4 million in 2012 and then $1.5 billion in 2013.[1] This CCEA forecast, however, does not include any capital projects beyond the Biosciences complex because the modeling technique already encompasses its own share of major projects. That said, even allowing for some delays in these projects, the *Outlook* may well underestimate the impact of this scale of capital projects.

In addition to the above projects, solid growth of Connecticut Real Personal Incomes (RPI) will help sustain growth over the next year. From 2010Q3 to 2011Q3, Connecticut RPI grew from $177.8 billion to $182.9 billion or 2.9%.

Overall, this *Outlook* sees Connecticut enjoying growth well above the national pattern through the end of this year, and the stimulus flowing from just the major biomedical initiatives in Farmington to raise the state's growth rate nearly 30% in 2012 and 15% in 2013 relative to the sluggish growth rate it would otherwise experience. Even more impressive, these initiatives more than double net new job creation over the new two years, compared to the baseline forecast. Clearly, these strategic public investments promise to deliver both strong short-run benefits and create the foundation of sustained long-term growth.

[1] http://www.capitalworkforce.org/documents/1109ConstructionReportFinal.pdf

Introduction

Downward revisions to U.S. national forecasts stemming from the European monetary crisis, parallel sharp reductions in projected European growth, the strengthening of the dollar against the Euro, weakening the competitiveness of American exports, Washington's political gridlock, and the resulting climate of uncertainty for commercial firms have combined to push leading economic indicators[2] down and cast an air of pessimism over the economy. This *Outlook*, surveying over 80 national forecasts, finds a consensus around the expectations the August Outlook established last quarter. It also reviews some leading indicators as well as the literature on how well these metrics have performed historically. In particular, there is considerable debate about the reliability of consumer sentiment to predict what consumers will do. Although initially only viewed in retrospect, economists' tried and true approach of "revealed preferences" is proving useful. In other words, assessments of consumer behavior should follow the dictum: "Believe what they do, not what they say"!

Modest Outlook for the Nation

CCEA, reviewing forecasts for the U.S. economy, found there is general consensus about performance in 2011. Because the first three-quarters of 2011 are history, there ought to be no great surprise about that level of agreement. Table 1 shows an emerging consensus among most forecasters that U.S. RGDP will grow about 1.8% in 2011. An apparent outlier is the Regional Seminar on Quantitative Economics (RSQE) at the University of Michigan, which has announced that it will be significantly lowering its 2011 forecast during the time of writing this publication.

Table 1: Real U.S. National GDP Growth Rates (% Change year on year)

Organization	2011	2012
Connecticut Center for Economic Analysis[1]	1.8	2.5-2.6
Regional Seminar on Quantitative Research[2]	2.3	2.9
U.S. Federal Reserve Board of Governors[3]	1.6-1.7	2.5-2.9
Consensus[4]	1.8	2.4

1) Connecticut Center for Economic Analysis, University of Connecticut, Storrs (Economic Outlook August 2011).
2) Regional Seminar on Quantitative Economics, http://rsqe.econ.lsa.umich.edu/Docs/RSQE-US-ForecastSummary(2011.09).pdf. This forecast has subsequently been adjusted significantly downwards. It will be revised mid-November and will be updated then.
3) http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20111102.pdf. Forecast revised downward from 2.7-2.9 and 3.3-3.7 for 2011 and 2012, respectively, from June projection. November 2, 2011.
4) Based on over 90 latest versions of forecasts from domestic and foreign financial intermediaries as well as academic sources.

There is clearly less agreement about growth in 2012. Since the end of August, as noted in the above Table, CCEA has lowered its national expectations for 2012 to the 2.5-2.6% range, remaining just above the consensus forecast but below RSQR and the Federal Reserve.

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[2] There are ten components in the Conference Board's Leading Economic Indicator (LEI) index. See The Conference Board's website (http://www.conference-board.org/) for additional information.

Researchers have paid much attention to consumer sentiment because of the heavy importance of consumption in the nation's economy. But of late it seems clear that consumers are not following their own expressed sentiments. Over the last year, even as consumer sentiment turned increasingly pessimistic, consumer action went in the opposite direction, with increasing purchases. Critically, this pattern of divergence between sentiment and actual behavior has increased over time[3].

Table 2 reveals the percentage change in consumption of every one percent change in consumer sentiment over time. This table provides the correlation indicator for actual consumer behavior against each percentage change in consumer sentiment. The numbers in this table reveal that the percentage change in actual consumption 1978 to 1989 was at or less than 31% of changes in consumer confidence; the relationship then weakened sharply, to less than 6% from 1990 to 2011Q2. Consumer opinions about durable purchases, while more emphatic, have had about 10-20% of the relationship to actual expenditures that held prior to 1990. This argues strongly against relying on consumer sentiment indicators to anticipate actual purchasing patterns.

Table 2: Elasticities of Consumption with Respect to Consumer Sentiment and Confidence

	1978-1989	1990-2011Q2
Consumer Sentiment University Of Michigan		
Total	0.047	0.008
Durables	0.274	0.059
Consumer Confidence Conference Board		
Total	0.040	0.004
Durables	0.310	0.034

Source: Ross DeVol, "Consumer Sentiment and Spending Watch What I Do, Not What I Say," Milkin Institute, Sept 2011, p. 8.

Whither Connecticut?

Connecticut RGDP

CCEA estimates that in 2011 Connecticut RGDP growth will outpace that of the nation. CCEA estimates CTRGDP by sector and statewide growth based largely on sector personal income. It also estimates GDP deflators from sector and national movements in consumer price indexes. From these dual projections, CCEA obtains an aggregate estimate of CTRDGP by quarter for 2011. As a check on its analysis, CCEA also estimates state CTRGDP in aggregate based on real personal income. Past experience reveals that the lesser of these two estimating procedures has been the more accurate once the actual performance becomes available. Despite taking the lower of the estimates, CCEA expects CTRGDP to grow at 2.64% in 2011, but then, without taking into account emerging projects such as UConn's Biosciences Center and Jackson Laboratories, to fade to 0.7% and 1.0% in 2012 and 2013.

As Chart 1 indicates, because the estimates do not take major emerging initiatives fully into account, that forecasting approach is downward biased, meaning that these forecasts represent a more negative scenario than the one Connecticut should achieve inclusive of the major projects. As an example of the importance

[3] Ross DeVol, Consumer Sentiment and Spending Watch What I Do, Not What I Say, Milkin Institute, Sept 2011.

of including these projects going forward, the upper (dotted) line of Chart 1 after 2011Q3 includes the early construction and partial staffing of the biosciences complex. It consists of initiatives to expand the UCHC School of Medicine and Dentistry and Jackson Laboratories announced expansion.[4] Just in its initial phases, the biosciences complex will boost CTRGDP growth to 0.9% in to 2012 and to 1.15% in 2013—this is more substantial that meets the eye, as it improves growth nearly 33% in 2012 and 15% in 2013.

Chart 1: State Output: 2008Q1-2013Q3, Excluding and Including Early Stages of Bioscience Connecticut

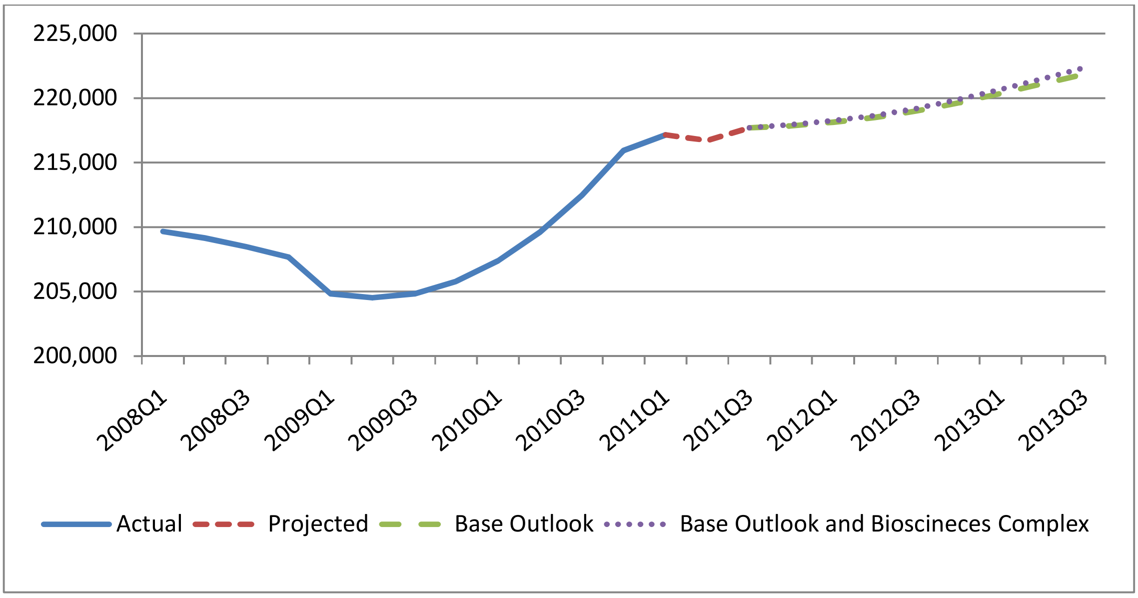
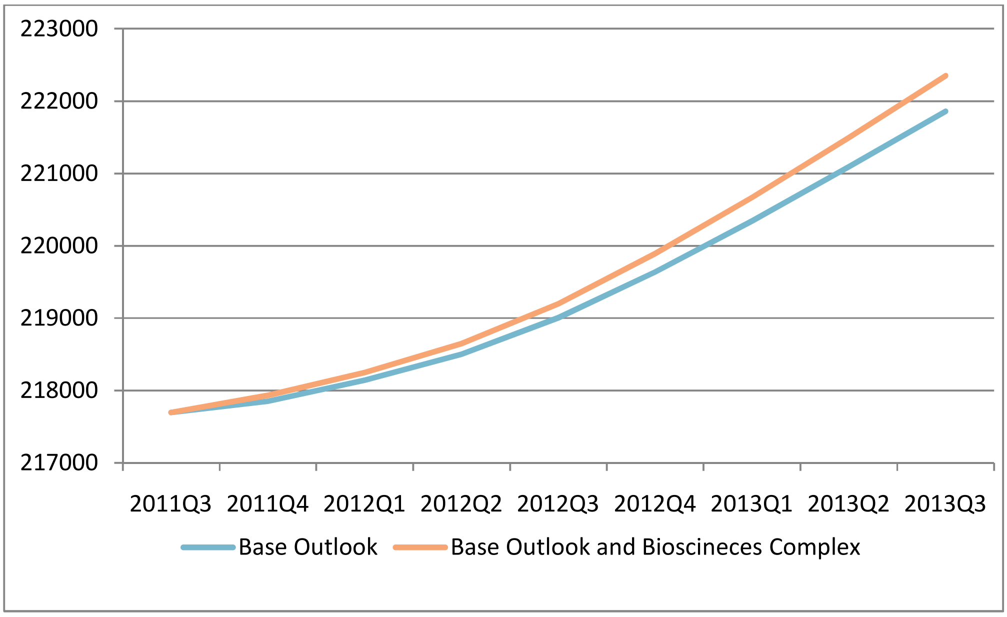


Chart 1A: CTRGDP Highlighting the Impact of Bioscience Connecticut Early Stages



[4] http://www.jax.org/news/archives/2011/ct-vote.html

To highlight the importance of combined impact of Bioscience Connecticut and Jackson Labs, Chart 1A above reproduces the anticipated growth in state output for the 2011Q3 to 2013Q3 section of Chart 1. These projects raise the rate of growth from 0.7% to 0.9% in 2012—nearly a 30% gain—and from 1.0% to 1.1% in 2013, a 15% gain. They will thus have a visible impact on the state's economic vitality.

Employment

The expansion of the UCHC School of Medicine and Dentistry, including the Biosciences Center, and the Jackson Laboratory development alone will add another 7,000 direct, indirect, and induced jobs to the already expected job creation of 11,000 in the baseline forecast for 2011Q1 to 2013Q3. Even in its early stages, construction of and hiring for the biosciences complex will add 66% to the jobs that would otherwise have been created during the period. Clearly additional growth in this cluster and other major projects may continue to expand Connecticut's employment. Chart 2 illustrates the differences in the two expansion paths, just for the Biosciences project itself.

Chart 2: Connecticut Employment 2009Q4-2013Q3 Excluding/ Including Bioscience Complex Early Stages

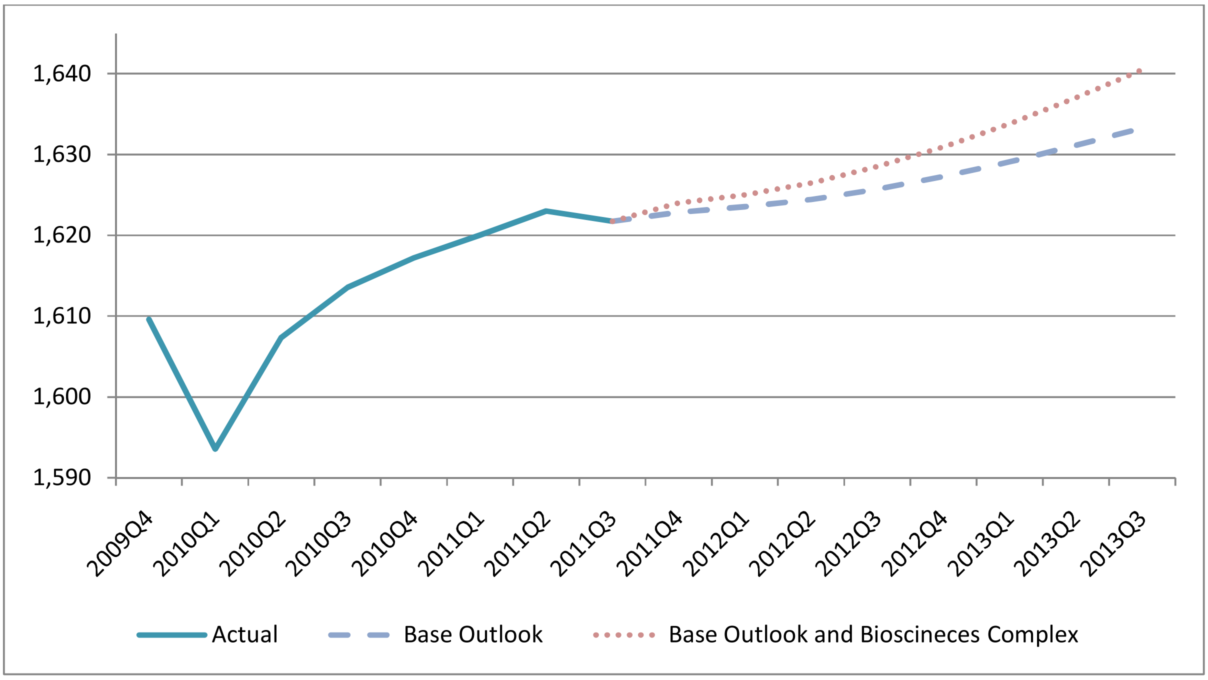
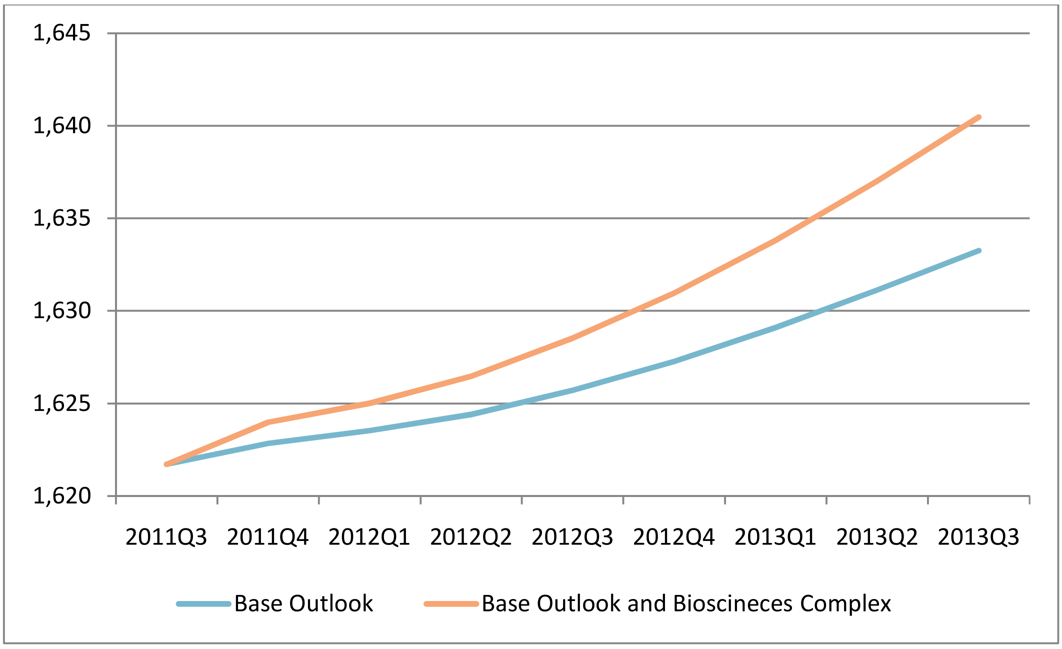


Chart 2A below reproduces just the forecast component of Chart 2 to emphasize the striking impact on employment of the opening stages of development of the bioscience complex in Farmington. These initiatives more than double the rate of job creation the CCEA baseline projection anticipated. This high level of payoff from these strategic public sector investments serves as a powerful reminder of the scale of benefit such government initiatives can deliver when properly designed.

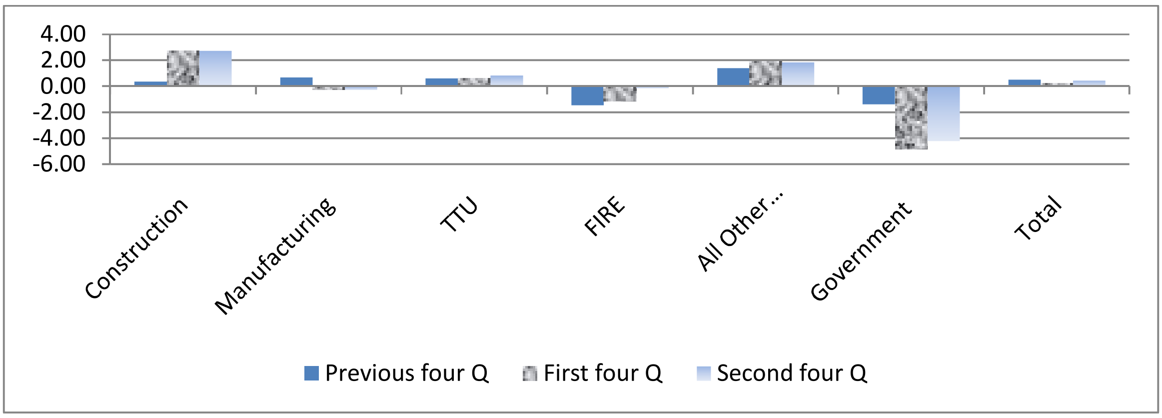
Chart 2A: Connecticut Employment 2011Q3-2013Q3: Highlighting the Impact of the Biosciences Complex



Employment by Sector

The modest employment forecast is consistent with the real sector rates-of-growth in the base case. Chart 3 illustrates employment estimates for each of the major sectors with government (inclusive of the casinos due to their ownership) treated as the residual. Declining government employment reflects both attrition in civil service positions and education cutbacks, and is consistent with the State's determination to redress its long-standing budget challenges and the continuing job losses among municipalities. During the past four quarters construction employment has begun to recover. With underlying demand for residential housing beginning to rise, CCEA anticipates an ongoing minor recovery in the construction section over the next eight quarters. It would of course be spurred further by the construction of the biosciences complex.

Chart 3: Four Quarter Base Case Employment Growth Rates by Sector 2010Q2 to 2013Q2



Manufacturing employment – after experiencing minor growth over the last four quarters – is not expected to continue to grow as global competition constrains Connecticut export growth in existing markets[5] and accelerates innovation by industry survivors. Overall state employment growth flows mostly from job creation in (1) trade, transportation and utilities (TTU) and (2) other services — defined as services other than finance insurance and real estate (FIRE) and (TTU).

With the biosciences center proceeding, this *Outlook* expects recovery in construction and continued growth in TTU and other services. However, CCEA is less bullish on continued manufacturing growth with some strengthening in the dollar, especially against the Euro (and therefore German competition). While a previous Quarterly documented the decline of the dollar since 2000 relative to most major trading partners, for nearly a year the USD-EUR has been, and continues to, trade within the $1.2750-1.4750 range.[6]

Major Connecticut Public Policy Initiatives

Significant Connecticut government policies have reduced public service benefits while proposing public sector investments. For these reasons, CCEA has adopted a balanced view of public policy initiatives, taking the following into consideration:

- $1 billion cut in fringe benefits over two years;
- A $1.7 billion tax increase;
- Construction of the 80% federally funded $567M[7] New Brittan-Hartford Bus-way during 2011-2013; and
- Initial construction and early hiring resulting from development the Biosciences Connecticut complex and Jackson Laboratories.

In aggregate, these initiatives should deliver a 66% increase over and above the base case in employment growth over the eight quarters. Employment is projected to be 7,000 higher compared to the base-case forecast, at 1,640,000 by 2013Q3, solidly above 2010 annual employment of 1,608,000.

At least half of the weaker employment totals in the base-case forecast result from about 21,000 fewer public sector jobs, including employment by Native American tribes, when comparing 2013Q3 to 2011Q3. Fewer job losses either in government or in the Native American casino operations could enhance the employment outlook.

[5] The New York Port Authority indicates that U.S. August exports of $13.1 billion where well below imports of $22.9 billion. Further, the gap has been widening with August 2011 compared to August 2010 exports growing at 10.3% and Imports at 18.7%. (NY Port Authority, *Monthly Economic Indicators*, October 2011.

[6] 6 http://www.dailyfx.com/technical_analysis.

[7] http://www.ctrapidtransit.com/News_Resources.htm Of these funds $487,734,000 remain to be expended after April 4, 2011. http://www.ctrapidtransit.com/Web_Briefing_April-4-2011.pdf. Completion is expected by late 2013. http://www.ctrapidtransit.com/May_2009_Open_House_Summary.pdf.

Conclusions

Even with the short-term pain caused by initiatives to rebalance the state budget, CCEA projects the Connecticut economy's real output and employment will continue to grow modestly.[8] In addition, this *Outlook* points to significant added growth in RGDP and employment flowing from development of the biomedical cluster in Farmington and other major projects.

Developing the biosciences cluster, with the twin anchors of the UConn health complex and Jackson Laboratories, establishes a leading-edge industry that is expected to contribute to the health and wealth of Americans for generations to come. Connecticut is now establishing the required elements to create the industry synergy that emerged at North Carolina's Research Triangle and along Route 128 in the Boston area. This health complex can deliver strong growth to the state for two decades or more. Thus, beyond the forecasting period, as the biosciences complex builds out and becomes fully operational, the impacts on Connecticut growth will continue to expand.

The remaining challenge is to articulate policies and programs that build on this initial success, with particular attention to retaining and growing strong, high-value sectors in the state's economy. The most obvious example is high precision manufacturing, in which Connecticut is both highly competitive in absolute terms and has improved its competitive position strikingly in the past decade. More broadly, as with the biosciences, Connecticut is deeply engaged in research and development activities. Addressing the poorly conceived policies that limit the use of accumulated tax credits, and prevent the conversion of this enormous fund of nearly $2.5 billion from a liability to an asset, is clearly the most important policy challenge the state confronts, and one critical to its future competitiveness.[9]

[8] Realistically, the only option to the policies adopted would have been dramatic budget reductions, which CCEA projected could have much larger negative impacts on both employment and output.

[9] Major firms have accumulated nearly $2.5 billion in tax credits whose use is highly restricted because, as constituted, they are a liability on current revenue. Converted to underwrite major capital projects, these credits become a major asset, driving extensive new construction and job creation. For a thorough analysis, see "Driving Recovery" on the CCEA website: http://ccea.uconn.edu/studies/Driving-Recovery-Report.pdf