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IN THIS ISSUE...

Connecticut and the Housing Bust: A Tale of Two Bubbles..... 1-5

Economic Indicators

on the Overall Economy	5
Individual Data Items	6-8
Comparative Regional Data	9
Economic Indicator Trends	10-11
Business & Economic News	15
Business and Employment Changes Announced in the News Media	19
Labor Market Areas:	
Nonfarm Employment	12-17
Sea. Adj. Nonfarm Employment	14
Labor Force	18
Hours and Earnings	19
Cities and Towns:	
Labor Force	20-21
Housing Permits	22
Technical Notes	23
At a Glance	24

In August...

Nonfarm Employment

Connecticut.....	1,624,800
Change over month	-0.42%
Change over year	+0.1%

United States	133,300,000
Change over month	+0.07%
Change over year	+1.4%

Unemployment Rate

Connecticut.....	9.0%
United States	8.1%

Consumer Price Index

United States	230.379
Change over year	1.7%

Connecticut and the Housing Bust: A Tale of Two Bubbles

By Daniel W. Kennedy, Ph.D., Senior Economist, DOL, Daniel.Kennedy@ct.gov

On July 18, 2012, the Center for Real Estate and Urban Economic Studies (CREUES) at the University of Connecticut released their study in which they found signs of stabilizing housing prices after more than a year of declines. They found that over the previous year prices had stabilized or increased throughout most of Connecticut's markets, and that those areas with declines also showed improvement with smaller drops.¹ Nationally, in their 2012 report released in June, the Joint Center for Housing Studies of Harvard University stated:

After several false starts, there is reason to believe that 2012 will mark the beginning of a true housing market recovery. Sustained employment growth remains key, providing the stimulus for stronger household growth and bringing relief to some distressed homeowners.²

They went on to caution:

While gaining ground, the homeowner market still faces multiple challenges. If the broader economy weakens in the short term, the housing rebound could again stall.³

The State, the nation, and parts of Europe are struggling to recover from the housing bubble that popped in the mid-2000s, followed by a financial panic. But the State, the region, and the nation have been here before.

Déjà Vu All Over Again

Before the popping of the housing bubble (and even now), many contended that housing prices, at least at the national level, had never declined before and that such a scenario was unthinkable. Even now many think that this is the first time that, nationally, housing prices have ever declined. George Santayana's famous words seem to be appropriate here: "Those who cannot remember the past are condemned to repeat it."⁴

The conventional wisdom had completely erased from memory the housing market boom and bust in the mid-1920s, and when it was recounted by John Kenneth Galbraith (1961)⁵ and others, it was seen as a madness that descended on and pretty much confined to Florida. That the housing market boom was nationwide and embodied many of the characteristics of the recent housing market bubble was, and for many still is, unknown.⁶ Beginning in 1926, the collapse of the housing market brought about a decline in aggregate investment and a weakening of household balance sheets, with a rising tide of foreclosures that contributed to and were worsened by the Great Depression. The boom of the twenties displayed many familiar characteristics, including surging housing starts and financial innovation (including mortgage securitization⁷), with strong regional elements; while the crash in the market produced rapidly rising foreclosures.⁸

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A Tale of Two Bubbles: The 1980s vs. the 2000s

Connecticut and New England have experienced two real estate bubbles and busts over the past 30 years. Ironically, it was the memory of the real estate bubble of the 1980s that implanted the myopia of the conventional wisdom that blinded many to the growing housing bubble in Connecticut and New England, as well as nationally, over the first decade of the 21st century. “History doesn’t repeat itself, but it does rhyme”⁹ might be the appropriate guide here. Even though Connecticut did not have as big a bubble or bust as the epicenters of the sub-prime mortgage/housing mania such as Las Vegas, Miami, and Southern California, its economy, nevertheless, has been significantly damaged by the housing boom and bust. To explore the reasons many missed the 2000’s housing bubble, it will be instructive to go back and review the critical features of the 1980’s housing bubble.

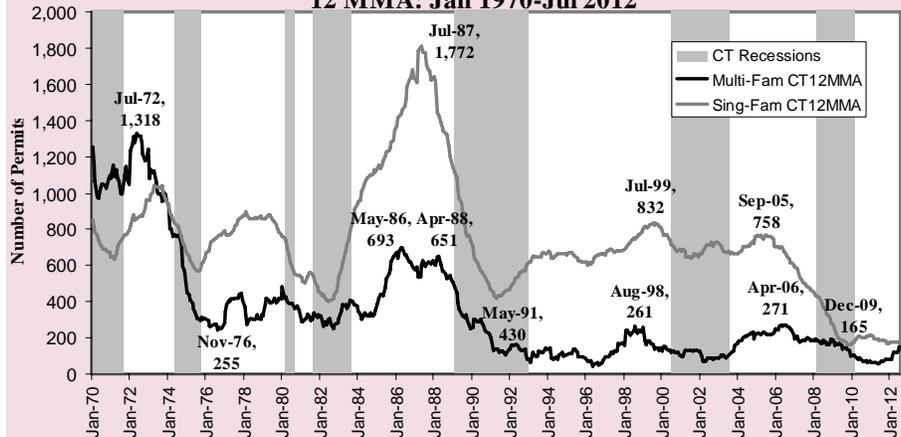
The 1980’s Real Estate Bubble

With the Reagan defense budget increase, Connecticut, with a manufacturing sector heavily concentrated in defense-related products in the 1980s, benefitted tremendously from the build-up, and as a consequence, the State’s economy boomed. Between 1983 and 1984, Connecticut’s average annual nonfarm employment grew by 74,075, a feat that has never been repeated since. The next highest annual gains, around or just under, 40,000 net new jobs per year were all between 1985 and 1987.¹⁰ Over that

same period, construction and real estate boomed as the State’s rapidly growing economy fueled population growth.

Graph 1 presents the 12-month moving average (MMA) of single-family and multi-family housing permits for Connecticut from January 1970 to July 2012. The 12-MMA is used to filter out the noise in the permits series. As a note of interest, notice that single-family permits did not pass up multiple-family permits until Connecticut came out of the 1973-75 recession. Multiple-family permits dropped from 1,318 in July 1972 to 255 in November 1976—an 80.65% decline. From that point on, the number of single-family permits has remained at two to four times above the level of multiple-family permits, and multiple-family permits have never returned to their pre-1972 levels. The peak of single-family permit activity was July 1987, when 1,772 permits were issued. Multi-family permits peaked at 693 in May 1986. After a decline, multi-family permits then peaked again at 651 in April 1988. Total annual permits (single-family and multiple-family) peaked at 26,794 in 1986. By 1989, annual total permits had fallen to 11,295, a 57.85% decline. With the popping of New England and Connecticut’s real estate bubble, single-family permits virtually collapsed. By May 1991, monthly permit levels fell to 430, a 75.33% decline. This was followed by the end of the Cold War and the subsequent restructuring of the insurance industry. This sequence of events plunged Connecticut into its Great Recession which lasted for 46

GRAPH 1: CT Multi-Family vs. Single-Family Housing Permits
12 MMA: Jan 1970-Jul 2012



months, from February 1989 to December 1992, and cost the State's economy 160,000 jobs.

The 2000's Real Estate Bubble

Before looking at why many missed the recent housing bubble, it will first be instructive to retrace the development of the 2000's real estate bubble, as was done above for the 1980's bubble. Unlike the 1980's New England real estate bubble, the 2000's housing bubble was not confined to several regions, but it was national—all regions were affected one way or the other (to be sure, some more than others). That makes it similar to the 1920's housing bubble discussed above. Parts of Europe, such as Portugal, Spain, and Ireland, also had housing bubbles, but for slightly different reasons. Nevertheless, the consequences were similar when they popped. There have been many explanations of why the 2000's housing bubble occurred. Whatever else drove it, the fuel for the fire was the explosion in the use of sub-prime mortgages in conjunction with the Greenspan policy of driving down interest rates ("Greenspan Put"), as well as deregulation and a lack of enforcing existing regulations of the financial system.¹¹ With the rise of structural securitization, which was the basis for manufacturing AAA-rated assets that served as collateral to secure short-term credit in the shadow-banking system, there was a rapid growth in the private secondary mortgage market. Further, both borrowers and lenders, in many instances, believed that house prices would continue to rise. For borrowers this meant they could gain equity in their homes through price appreciation and qualify for a conventional mortgage before their adjustable-rate mortgage (ARM) re-set at higher monthly payments. For lenders, "never-

ending" home-price increases meant that if the borrower defaulted they could easily sell the home and get their money back, and then some, through the appreciation in its price. This generated and reinforced the positive feedback effects of the bubble mentality where an increase in an asset's price stimulates rather than dampens demand. That is, subsequent price increases actually reinforce and magnify the initial price increase rather than offsetting it and bringing it back to some equilibrium level.¹² Further, many borrowers, and supposedly sophisticated investors, did not understand these complex instruments.

Though not as affected by the housing bubble, Connecticut has been affected by foreclosures driven by the sub-prime mortgage problem and a significant presence of the financial sector, the epicenter of the panic, and subsequent steep recession. However, there was also something else going on. Particularly, with regard to recognizing that, Connecticut too was heading for a housing bust—again. The initial blindness to the bubble by many was due to "looking in the wrong place," which may not have occurred had it not been for the 1980's real estate bubble. Once again, history behaves like an O. Henry story and gives us that ironic twist. Referring back to Graph 1, those discounting the idea of a housing bubble in Connecticut pointed to the level of housing permits throughout the 2000s. The peak month for single-family permits in the 1990's was July 1999, the peak year of the Tech Boom, when 832 permits were issued. The peak for multi-family permits was the 261 issued in August 1998. The peak number of single-family permits never got as high as it did in the 1990s. The peak level was 758 in

September 2005. Multi-family permits did slightly surpass their 1990s peak reaching a level of 271 in April 2006. But these numbers were significantly below the peak levels of the 1980's. So, what drove the recent housing crash if there were no oversupply?

We Won't Get Fooled Again?

As shown in Table 1, Connecticut's permit activity did not come close to that of two selected bubble epicenter states for comparison: Nevada and Florida. An index of annual permit data was constructed such that each year is the ratio of the number of permits in the given year to the base year of 2000 which equals 100.00. All three states' permit activity peaked in 2005. Between 2000 and 2005, Nevada's annual total number of housing permits grew by 47.83%, and Florida's grew by 85.00%. But the number of annual permits issued in Connecticut only grew by 26.76%. Though Connecticut's collapse in housing permits was not as steep as the more than 87% decline in Nevada and Florida, Connecticut's permit activity still declined by 73.30% between 2005 and 2011. This matches the 73.05% collapse in Connecticut's annual permit activity after the popping of the 1980's real estate bubble between 1986 and 1991. Yet, between 1980 and 1986, annual total housing permits grew by 174.88%. What happened?

It is this muted behavior in housing permits, not only relative to the epicenter states but relative to Connecticut's own experience in the 1980s, that caused many to refute the idea that Connecticut too may be in a housing bubble. Giving weight to their argument between 1984 and 1987 at the peak of the 1980's bubble, total housing permits exceeded 20,000 per year, but during their peak in the 2000s,

TABLE 1: Index of Total Housing Permits 2000-11- CT and Selected Bubble Epicenters

	BASE PERIOD*		% CHANGE	TROUGH TO		PEAK TO			
	PERIOD*	PEAK**		TROUGH***	% CHANGE	2012Q2	% CHANGE	2012Q2	% CHANGE
CT	100.00	126.76	26.76	33.84	-73.30	NA	NA	33.84	-73.30
NV	100.00	147.83	47.83	19.09	-87.09	NA	NA	19.09	-87.09
FL	100.00	185.00	85.00	22.75	-87.70	27.28	19.90	19.09	-89.68

SOURCE: U.S. Census Bureau

*Base period is the year 2000 where the Permits Index = 100.00

** Peak for all three states, based on annual data, was 2005

***Trough was in 2011 for CT and NV (as of 2011) and 2009 for FL

between 2003 and 2005, they only slightly exceeded 10,000,¹³ which were still only one-half the peak annual permit levels of the 1980's.¹⁴ Clearly there was no oversupply of housing units. Further, many argued that restrictive zoning was putting a constraint on building activity, and if anything, Connecticut was facing a housing shortage.

The answer to the conundrum lies in Graph 2 and what it reveals. Graph 2 tracks the YTY change in the three-year moving average (3-YMA) of total Connecticut households and number of housing units from 1983 to 2011.

Critical to housing demand is household formation. Specifically, it is net household formation that is a critical factor driving the change in overall housing demand. As is clear from Graph 2, in the 1980s the YTY growth in 3-YMA of the supply of new housing units at some point overshot the increase in the YTY growth in 3-YMA of demand (i.e., household formation). As research has shown,¹⁵ with the regional economy's plunge into recession, net household formation began to rapidly decline, and after 1992 it contracted. This decline in demand exacerbated the growing inventory of units on the market from boom-turned-bubble driven oversupply, as supply, as measured by the YTY change, outstripped demand (i.e., household formation) after 1986. As outmigration accelerated with the increasingly severe economic contraction, as depicted in Graph 3, the YTY change in 3-YMA of the number of vacant housing units surged and peaked at 10,992 in 1994, the year which had the

steepest YTY decline in net household formation.

With the end of Connecticut's Great Recession and the Tech Boom/Bubble of the late-90s, Connecticut regained some of its lost population back. As shown in Graph 2, the 3-YMA of YTY net household formation surged between 1994 and 2000, and in 2000, the number of vacant housing units declined by 17,125. However, the growth in the number of housing units did not keep pace and remained flat. By 1999, the YTY rate of net household formation began to far outstrip the YTY growth in housing units.

However, with the onset of recession in Connecticut in July 2000, and the generally weak expansion following the 2001 U.S. recession, Connecticut's annual net household formation began declining after 2001. By 2005, net household formation fell below the YTY growth in the number of housing units. In 2007, household formation contracted for the first time since 1992. As depicted on Graph 3, the YTY growth in the number of vacant units in 2007, at 11,084, exceeded the peak YTY growth in the number of vacant units of the 1980's real estate bust which ushered in the popping of Connecticut's second housing bubble within 30 years. While most were gauging whether or not there was an excess of supply as the indicator of excess inventory in the housing market, this time it was the collapse in demand that drove the explosion of excess inventory in the State's housing market.

Paper, Scissors, and Housing Bubbles

What is critical here is the gap between supply and demand. It does not matter whether a given excess supply on the market is due to supply playing the active role by overshooting demand, or whether demand takes the active role by falling rapidly and significantly while holding supply constant. In his *Principles of Economics* Alfred Marshall wrote:

We might as reasonably dispute whether it is the upper or the under blade of a pair of scissors that cuts a piece of paper, as whether value is governed by utility or cost of production. It is true that when one blade is held still and the cutting is affected by moving the other, we may say with careless brevity that the cutting is done by the second; but the statement is not strictly accurate, and is to be excused only so long as it claims to be merely a popular and not a strictly scientific account of what happens.¹⁶

Both blades are involved in cutting the piece of paper. A market is made up of *both*: supply *and* demand. Equilibrium is determined by the intersection of *both* the supply *and* demand curves. Neglecting one or the other is leaving out critical information about the condition of the market. ■

¹ Masroor, Aroosa, *Study shows Connecticut's housing market stabilizing* (July 18, 2012) THE CTMIRROR <http://www.ctmirror.org/story/16948/study-shows-connecticuts-housing-market-stabilizing>. Accessed on August 27, 2012.

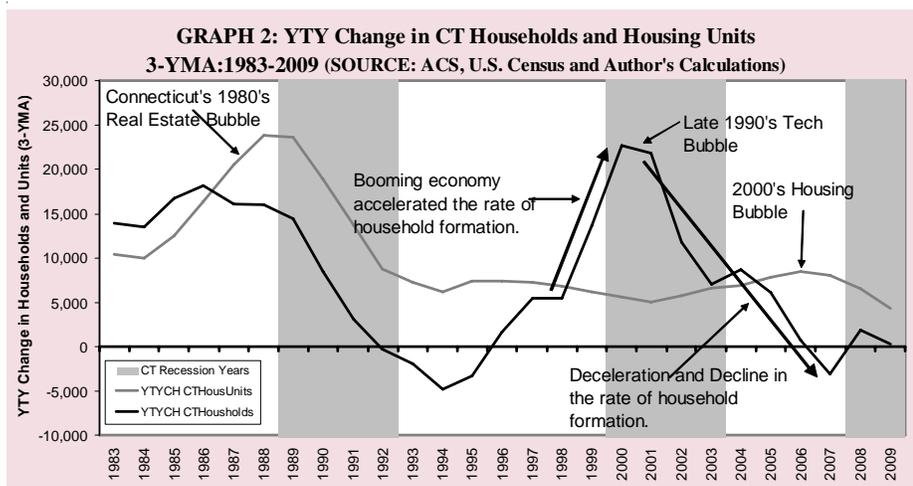
² Executive Summary, THE STATE OF THE NATION'S HOUSING: 2012 (June 2012) Joint Center for Housing Studies of Harvard University: Cambridge, MA, p. 1.

³ *ibid.*

⁴ Santayana, George, REASON IN COMMON SENSE, Volume 1: *The Life of Reason* (1905) Dover Paperback Edition (June 1980).

⁵ Galbraith, John Kenneth THE GREAT CRASH, Pelican (1961).

⁶ White, Eugene N, *The Great American Real Estate Bubble of the 1920s* (October



2008) National Bureau of Economic Research: Cambridge, MA.

⁷ See Goetzmann, William N. and Frank Newman, SECURITIZATION IN THE 1920'S (January 2010) National Bureau of Economic Research: Cambridge, MA.

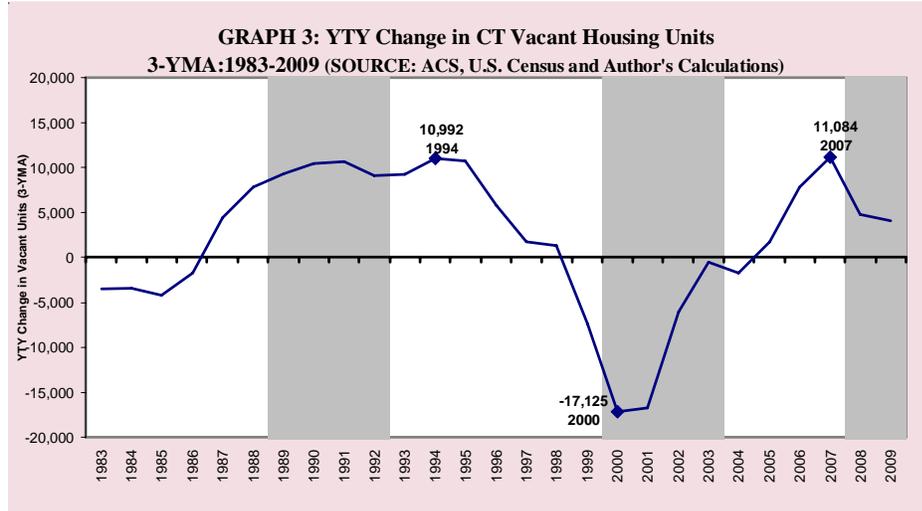
⁸ White (October 2008).

⁹ This has most frequently been attributed to Mark Twain (see QuoteDB.Com <<http://www.quotedb.com/quotes/3038>>), but it has also been attributed to Will Rogers and others.

¹⁰ CT DOL-Office of Research, Current Employment Statistics.

¹¹ Some put all the blame on FANNIE and FREDDIE and Presidents Clinton and Bush's programs to extend homeownership through the *Community Reinvestment Act* (CRA). But the problem with that argument is that the sub-prime mortgage originators, including the largest, Countrywide, and others such as Ownit, Ameriquest, Household Finance, and others at the time were not depository institutions, or not yet owned by one, and therefore not subject to the CRA, or under the jurisdiction of FANNIE and FREDDIE. Further, FANNIE and FREDDIE could not directly securitize sub-prime mortgages, though they did purchase some toxic assets created from them.

¹² For some suggested sources of accounts of the causes and consequences of the housing bubble, see Muolo, Paul and Mathew Padilla, CHAIN OF BLAME:



How Wall Street Caused the Mortgage and Credit Crisis (2008) John Wiley & Sons: New York; Tett, Gillian, FOOL'S GOLD (2009) Free Press; Gorton, Gary B, SLAPPED BY THE INVISIBLE HAND: The Panic of 2007 (2010) Oxford University Press; Cassidy, John, HOW MARKETS FAIL: The Logic of Economic Calamities (2009) Farrar, Straus and Giroux; Bookstaber, Richard, A DEMON OF OUR OWN DESIGN (2007) Wiley: New York; Morris, Charles R, THE THREE TRILLION DOLLAR MELTDOWN: Easy Money, High Rollers, and the Great Credit Crash (2008) PublicAffairs; Fleckens, William, GREENSPAN'S BUBBLES: The Age of Ignorance at the Federal Reserve (2008) McGraw-Hill: New York; and The Financial Crisis Inquiry Commission, THE FINANCIAL CRISIS INQUIRY REPORT (January 2011) U.S. Government Printing Office: Washington.

¹³ Housing permits also exceeded 10,000 per year in 1998 and 1999 during the Tech Boom.

¹⁴ U.S. Census, Housing Permits by State 1960-2011, <http://www.census.gov/construction/bps/xls/annualhistorybystate.xls> Accessed on August 29, 2012.

¹⁵ Painter, Gary, *What Happens to Household Formation in a Recession?* (April 2010) Research Institute for Housing America, Mortgage Bankers Association.

¹⁶ Marshall, Alfred, PRINCIPLES OF ECONOMICS (1890) MacMillan and Co.: London and New York, Book V, Chapter 3- *Equilibrium of Normal Demand and Supply*, p. 348.

GENERAL ECONOMIC INDICATORS

<i>(Seasonally adjusted)</i>	2Q	2Q	CHANGE		1Q
	2012	2011	NO.	%	2012
General Drift Indicator (1986=100)*					
Leading	106.4	103.8	2.6	2.5	106.8
Coincident	107.3	107.3	0.0	0.0	107.2
Farmington Bank Business Barometer (1992=100)**	124.0	124.1	-0.1	-0.1	124.2
Philadelphia Fed's Coincident Index (July 1992=100)***	AUG	AUG			JUL
<i>(Seasonally adjusted)</i>	2012	2011			2012
Connecticut	152.15	150.18	1.97	1.3	152.65
United States	151.22	147.28	3.95	2.7	151.00

Sources: *The Connecticut Economy, University of Connecticut **Farmington Bank ***Federal Reserve Bank of Philadelphia

The Connecticut Economy's **General Drift Indicators** are composite measures of the four-quarter change in three coincident (Connecticut Manufacturing Production Index, nonfarm employment, and real personal income) and four leading (housing permits, manufacturing average weekly hours, Hartford help-wanted advertising, and initial unemployment claims) economic variables, and are indexed so 1986 = 100.

The **Farmington Bank Business Barometer** is a measure of overall economic growth in the state of Connecticut that is derived from non-manufacturing employment, real disposable personal income, and manufacturing production.

The **Philadelphia Fed's Coincident Index** summarizes current economic condition by using four coincident variables: nonfarm payroll employment, average hours worked in manufacturing, the unemployment rate, and wage and salary disbursements deflated by the consumer price index (U.S. city average).