FEDERAL RESERVE BANK OF NEW YORK
Volume 5 Number 11

CURRENT ISSUES IN ECONOMICS AND FINANCE

Second district highlights

July 1999

Can New York City Bank on Wall Street?

Last year, financial turmoil around the globe raised concerns that New York City's securities industry could be headed for a severe downturn. The lingering effects of Asia's economic troubles, currency crises in Russia and Brazil, and a significant correction in the U.S. stock market resulted in a tumultuous summer for the financial markets. In response, several financial firms in New York City announced major job cuts, and the city's commercial and residential real estate markets froze.

Although the distress in the financial markets proved temporary, serious concerns about the vulnerability of the local economy to additional financial shocks remain. The revenues of securities firms have played an important role in the city's strong economic recovery, and any significant decline in the industry could hurt the local economy. Indeed, a sharp drop in securities employment preceded the city's two deepest economic slumps in the postwar period.

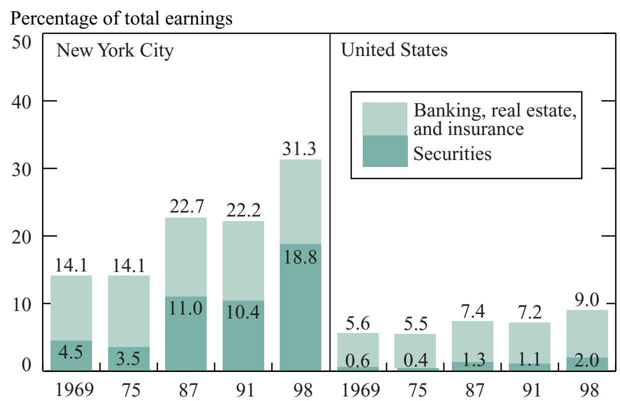
In this edition of *Second District Highlights*, we examine Wall Street firms' contribution to the New York City economy, particularly in the current expansion, and assess how a reversal in the performance of the financial markets might affect overall employment.[1] We find that the securities industry is more important than ever to the local economy and that a protracted downturn in the industry's employment could seriously hurt the overall job picture. Increased stability in other New York City industries, however, could help soften the economic effects of such a downturn.

Wall Street and the New York City Economy

Although a number of services industries are firmly entrenched in New York City, the FIRE sector (finance, insurance, and real estate) is of critical importance to the local economy. The FIRE sector currently accounts for 14 percent of total employment in New York City, more than double the national average. Within the sector, the securities industry accounts for 4.7 percent of New York City's total employment, or roughly ten times the national average. Even more impressive is Wall Street's contribution to earnings. In 1998, the securities industry generated an estimated 19 percent of total city earnings, compared with 2 percent nationally (Chart 1).[2]

The securities industry—always a prominent force in the local economy—has increased greatly in importance over the past several decades. Wall Street's share of total city earnings in 1998 was substantially higher

Chart 1
Financial Services' Share of Total Earnings: New York City and the Nation



Sources: U.S. Department of Commerce, Bureau of Economic Analysis; New York State Department of Labor.

Note: Figures for 1998 are Federal Reserve Bank of New York staff estimates based on data from the first three quarters of 1998.

than in 1987 and more than four times its share in 1969. Moreover, during the city's present expansion, the securities industry has been the primary source of earnings growth: between 1994 and 1998, securities firms contributed about $23 billion (or 37 percent) to the estimated $62 billion increase in total earnings—much more than in the nation as a whole (Chart 2).[3]

In addition to generating a healthy share of the city's earnings, the securities industry is an important source of revenue for a wide range of other businesses. For example, publishing, accounting, marketing, legal, computer, and business services companies all supply key inputs to financial firms. Thus, when the securities industry weakens, these companies typically see a slowing in demand for their products and services. The high earnings produced by the securities industry also help fuel other business activity. For example, fluctuations in Wall Street paychecks tend to influence the fortunes of the city's retail, restaurant, and entertainment industries.

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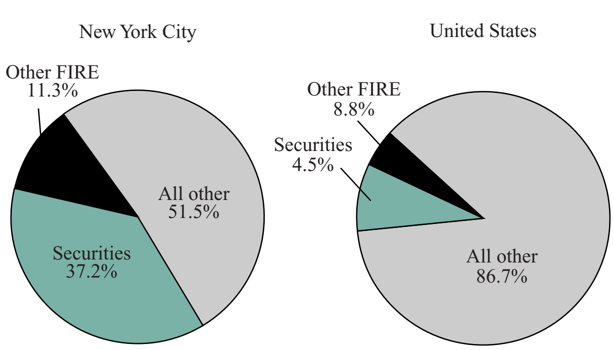
Taking into account the industries that directly support Wall Street and the industries that benefit from Wall Street income, the Commerce Department has estimated that each job in the city's securities industry generates about two additional city jobs.[4] According to this estimate, roughly 14 percent of total employment in New York City is related, either directly or indirectly, to the securities industry.

Wall Street and Overall Employment

Because Wall Street firms are so essential to New York City's economy, one would expect movements in securities employment to lead movements in the city's aggregate employment. Indeed, overall employment growth patterns have closely followed the industry's patterns over the past several decades (Chart 3). This historical link helps explain the uneasiness following the announcement of securities industry cuts last summer.

An important question, then, is what determines the growth patterns of securities employment? One of the most important factors is the performance of the U.S. stock market. As we would expect, prolonged periods of weakness in stock prices have typically brought about a decline in employment in the securities industry (see Chart 4, top panel). In some cases, however, this

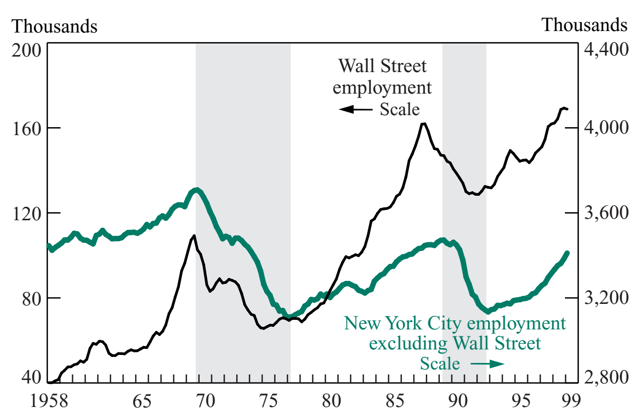
Chart 2
Industry Contributions to Total Earnings Growth in New York City and the Nation: 1994-98



Sources: U.S. Department of Commerce, Bureau of Economic Analysis; New York State Department of Labor.

Note: Figures for 1998 are Federal Reserve Bank of New York staff estimates based on data from the first three quarters of 1998.

Chart 3
Wall Street Employment and Total Employment



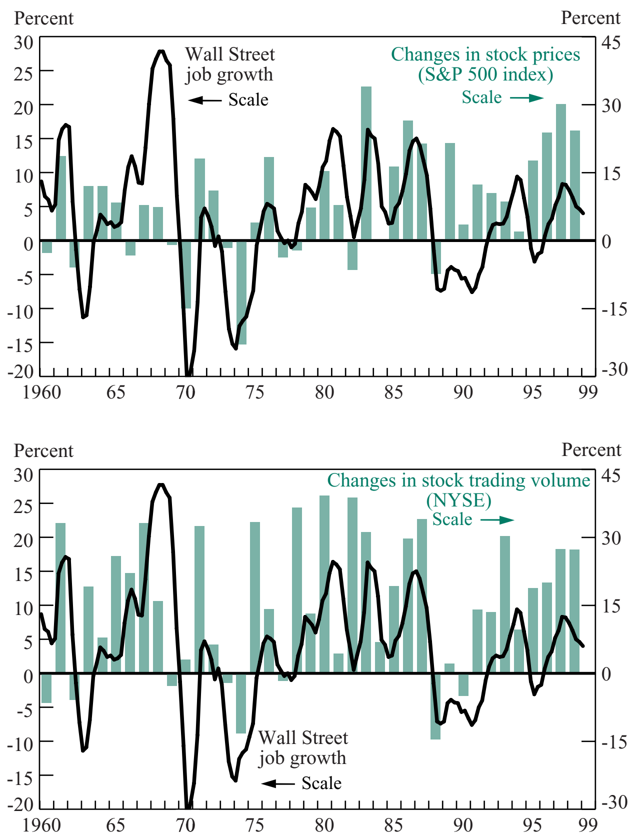
Sources: U.S. Department of Labor, Bureau of Labor Statistics; New York State Department of Labor.

Notes: Data were seasonally adjusted by Federal Reserve Bank of New York staff. Shaded areas represent peaks and troughs in New York City employment.

relationship has not held. For example, falling stock prices in 1966 and in 1982 had a surprisingly modest effect on the growth of Wall Street firms. By contrast, the October 1987 stock market crash—which was both preceded by and followed by strong stock market gains—led to an unexpectedly severe and persistent downturn in the industry's employment. In these cases, trading volume appears to have been instrumental in determining how hard movements in the stock market hit securities employment (Chart 4, bottom panel).[5] Thus, although an important factor, stock prices alone do not always determine the extent of swings in Wall Street employment.

Chart 4

The Effect of Stock Prices and Trading Volume on Wall Street Job Growth



Sources: New York State Department of Labor; *Wall Street Journal*; New York Stock Exchange (NYSE).

Note: Stock prices and trading volume are reported as annual percentage changes; Wall Street employment is reported as a four-quarter percentage change.

To gain further perspective on how a securities industry slump might affect New York City's economy today, we examine the industry's role in the city's two steepest postwar downturns.[6]

A Look at Two Major Downturns

Between early 1969 and late 1974, falling stock prices derailed the securities industry—the Standard and Poor's 500 index plummeted 32 percent,[7] and Wall Street employment and real earnings each tumbled 34 percent. In the corresponding 1970-76 downturn in the city's overall economy, total employment fell 15 percent and real earnings fell 9 percent.

By contrast, the city's 1989-92 slump came during a time when, for the most part, stock prices were on the rise. To the surprise of many observers, the 1987 stock market crash was short-lived, and the S&P 500 index rose steadily over the next several years.[8] Although stock prices stayed relatively strong, growth in stock trading volume fell sharply in the years following the 1987 crash. Moreover, recent research indicates that downsizing in the financial sector during this period represented a major drag on local job growth (Kuttner and Sbordone 1997). Between 1988 and 1991, Wall Street employment fell 16 percent and real earnings dropped 12 percent. About one year into the securities industry downturn, the overall economy also faltered: from 1989 to 1992, total employment fell 9 percent and real earnings dropped 3 percent.

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Although a large factor in New York City's two major downturns, Wall Street was not the only source of weakness. Shrinkage in the manufacturing, real estate, and government sectors also hurt the metropolitan area. In addition, in both the 1970s and the early 1990s, a weak national economy added to New York City's economic woes. The national economy contracted in both 1970 and 1974, resulting in sharp employment reductions in a number of sectors. The national economy again experienced a recession in 1990 and an unusually slow recovery in employment over the 1991-93 period.

Potential Effects of a Securities Industry Downturn

What conclusions can we draw from reviewing Wall Street's role in the city's 1970-76 and 1989-92 downturns? First, as we have seen, cycles in the securities industry tend to lead cycles in the local economy. Second, because Wall Street represents a much larger share of the city's economy than at any time in the past, a significant downturn in the industry could result in more severe employment and income losses than those recorded in the 1970s or the early 1990s. Finally, the consequences of a setback in the city's securities industry depend on how other parts of the economy are faring.

The increased role of Wall Street in the city's growth has been accompanied by strength in other areas of the economy.

Fortunately, the increased role of Wall Street in the city's growth has been accompanied by strength in other areas of the economy. Specifically, several sectors that underwent a severe retrenchment in earlier downturns appear to be on more solid footing in this expansion. Because of this shift, the city's overall economy may be in better shape to weather a reversal on Wall Street than in the past. The sectors that would likely pose less economic risk include the following:

- *Manufacturing.* One of the chief contributors to New York City's slump in the early 1970s was the manufacturing sector. Cutbacks there directly accounted for almost half of the city's job losses and more than two-thirds of the decline in real earnings. In the 1989-92 slump, the manufacturing sector was again a severe drag on the local economy. Today, manufacturing accounts for just 6 percent of local earnings, down from 20 percent in 1969. Because its importance to the city's economy has diminished significantly, another decline in the manufacturing sector would likely put far less pressure on the local economy than was true in previous downturns.

- *Real Estate*. In the late 1960s and again in the mid-1980s, the city experienced a burst in speculative construction. Projections of market demand in both periods proved to be overly optimistic, however, and a huge excess supply of office space and housing developed as Wall Street employment and income began to shrink. By contrast, builders over the past several years have engaged in fewer speculative projects. Thus, in the event that Wall Street income falters, the city should not face a large oversupply of space.

- *Government*. In the past, city government employment rolls typically increased during periods of strong economic growth. Over this expansion, however, city government employment has declined, even as tax revenues have soared. This relatively lean approach to staffing should leave the sector less vulnerable to employment cuts in the event of a downturn.

Another factor working to the city's advantage is the presence of several fast-growing industries that are not directly tied to the financial industry—for example, health care, private education, motion pictures, and new-media enterprises.[9] The rising importance of these industries to the economy could help soften the impact of a modest decline in Wall Street employment and earnings (Orr and Rosen 1998). Recent research indicates, however, that the regional economy is more closely tied to national business cycles than in the past (McCarthy and Steindel 1997). This means that a slowdown in the U.S. economy could aggravate the overall effects of securities industry cuts.

Conclusion

A steep decline in Wall Street jobs and income would likely require a sustained drop in stock prices and weakness in other aspects of financial market activity. In the event that adverse market conditions do generate a substantial downturn in the securities industry, New York City's economy as a whole would undoubtedly suffer. The securities industry plays a greater role in the city's economy than ever before, and it is unlikely that the effects of cuts in Wall Street jobs and income could be absorbed by other industries. Nevertheless, developments over the last decade could help the local economy avert a replay of the severe 1970-76 and 1989-92 downturns. In these downturns, imbalances in several of the city's key nonfinancial sectors compounded the adverse impact of a weakening securities industry. These sectors, however, appear to have grown more stable in recent years. Moreover, the presence of several fast-growing industries that do not depend directly on financial earnings could help contain the effects of a securities industry downturn.

—Jason Bram and James Orr

Notes

1. Although we acknowledge that a securities industry decline would have a large effect on local tax revenues, we do not directly address this effect in the article. See McCall (1998) for a discussion of the fiscal implications of securities industry performance.

2. New York City dominates the securities industry in the New York–New Jersey region, accounting for 76 percent of employment and 86 percent of earnings.

3. The year 1994 was selected as the base year because tax-related shifts in the timing of bonuses distorted earnings figures in 1992 and 1993. Earnings reflect wages and salaries and are drawn from the Bureau of Labor Statistics' tabulations of earnings of the insured employed.

4. Data on Wall Street–related employment are from the U.S. Department of Commerce's Regional Input-Output Modeling System.

5. Although trading volume was relatively high following the stock price declines of 1966 and 1982, it fell significantly in the wake of the 1987 crash.

6. For estimates of the contribution of the national economy, the finance sector, and region-specific factors to the 1970-76 and 1989-92 downturns in the New York City metropolitan area, see Kuttner and Sbordone (1997).

7. The real (inflation-adjusted) decline in the S&P 500 index was more than 50 percent.

8. On an annual average basis, the S&P 500 index rose 21 percent in 1987. Although the index declined 7 percent in 1988 (reflecting the October 1987 stock market crash), it went on to rise 21 percent in 1989, 4 percent in 1990, and 12 percent in 1991.

9. For a look at New York City's fast-growing new-media industries, see Bram and De Mott (1998).

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Second District Highlights, a supplement to *Current Issues in Economics and Finance*, is published by the Research and Market Analysis Group of the Federal Reserve Bank of New York. Dorothy Meadow Sobol is the editor.

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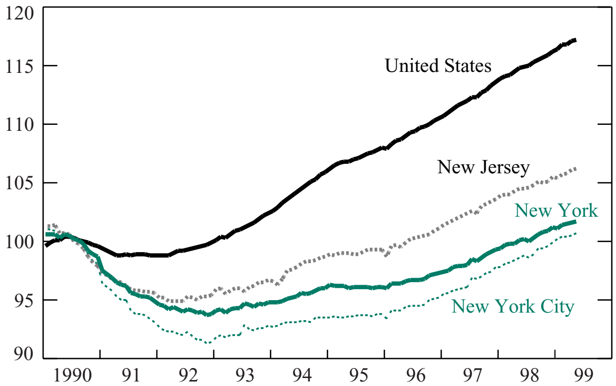
Economic Trends in the Second District

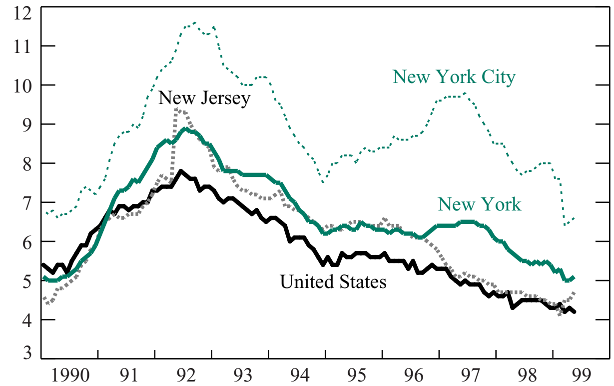
Payroll Employment

Index: 1990 = 100 (seasonally adjusted)



Unemployment Rates

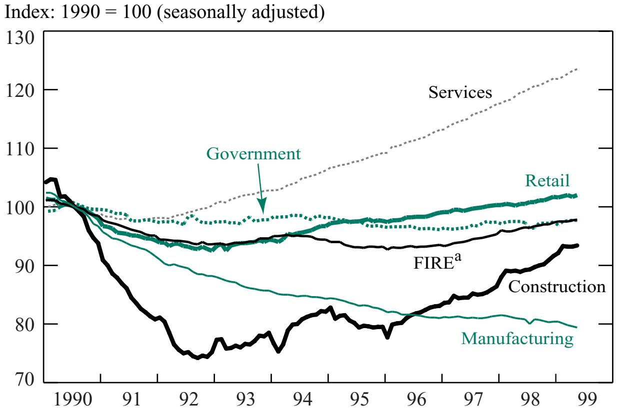
Percent (seasonally adjusted)



Payroll Employment in Selected Sectors

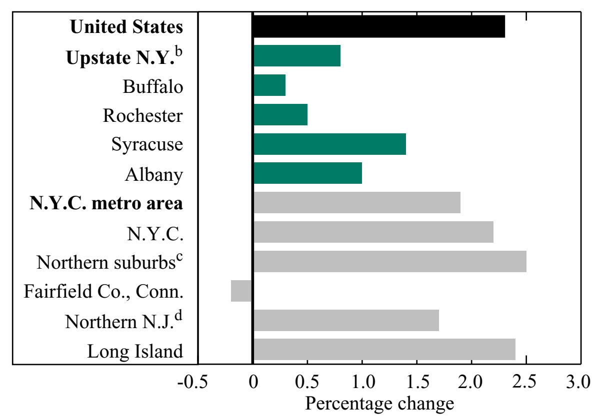
New York and New Jersey Combined

Index: 1990 = 100 (seasonally adjusted)



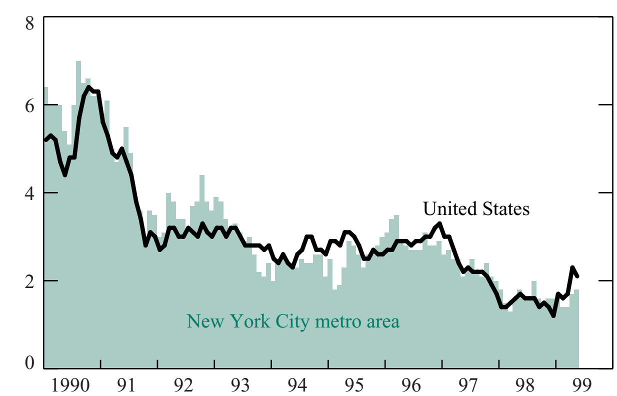
Job Growth in the Nation and Selected Metropolitan Areas

March-May 1998 to March-May 1999



Regional and National Inflation

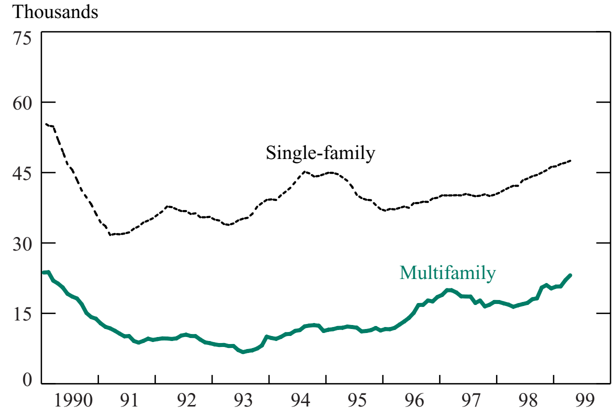
Twelve-Month Percentage Change in Consumer Price Index



Housing Permits in New York and New Jersey Combined

Twelve-Month Moving Average, Annual Rate

Thousands



Sources: New York, New Jersey, and Connecticut Departments of Labor; U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of the Census; Federal Reserve Bank of New York.

[a] FIRE = finance, insurance, and real estate.

[b] Upstate N.Y. comprises the four metropolitan areas listed as well as Binghamton, Elmira, Glens Falls, Jamestown, and Utica-Rome.

[c] The northern suburbs of N.Y.C. comprise Dutchess, Orange, Putnam, Rockland, and Westchester Counties, N.Y., and Pike County, Pa.

[d] Northern N.J. comprises Bergen, Essex, Hudson, Hunterdon, Mercer, Middlesex, Monmouth, Morris, Ocean, Passaic, Somerset, Sussex, Union, and Warren Counties.