



# Hampton Roads Economic Quarterly

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**About this Document**

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**Sequestration and the Hampton Roads Economy** By James Clary

**Why Sequestration-**

The long term operating deficit of the U.S. government, coupled with mounting accumulated debt, inspired the Budget Act of 2011 as a response to that summer's debt ceiling crisis. Both political parties agreed that significant cuts were needed in Federal spending, and the Budget Act called for immediate deficit cuts of \$917 billion over 10 years. The Act also created the Super Committee (or Joint Select Committee on Deficit Reduction) to make a further \$1.5 trillion in cuts over the next 10 years; however, if there was no deficit reduction agreement then a process of **sequestration** would be implemented.

The sequestration mechanism triggered across-the-board reductions of \$1.2 trillion dollars (over ten years) on all Federal programs excluding Medicaid, Social Security, and Federal pay. The Congressional Budget Office (CBO) estimated the final budget impact would actually be closer to \$1.1 trillion as a result of delayed implementation. Additionally, the CBO indicates, "the reductions in the caps for Defense programs would be proportionately larger than the reductions in the caps for nondefense programs." Separately, the White House estimates in a September 2012 report that there would be a 9.4% across-the-board cut in defense programs and an 8.2% reduction in money for domestic programs; the variance between estimates reflect the uncertainty around the final impact.

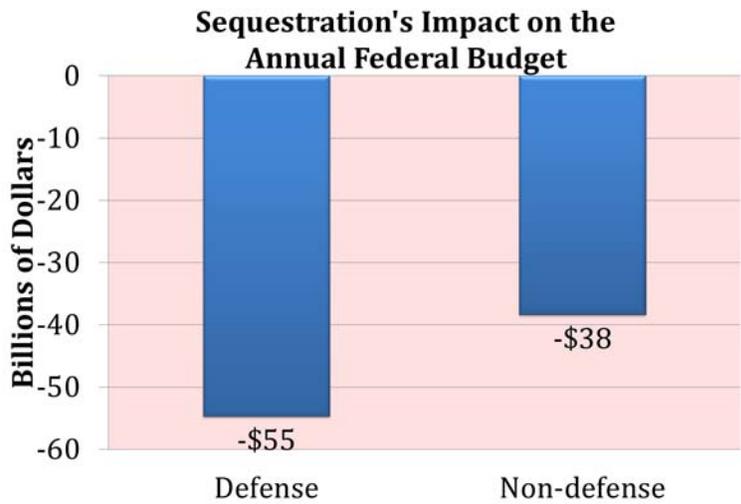
**Why should Hampton Roads Care about Sequestration**

The Federal government, particularly the Defense industry, plays an important role in the regional economy. Historically, Hampton Roads has outperformed the national economy during periods of high defense spending, and underperformed when the Department of Defense suffered spending cuts.

**Fiscal Cliff vs. Sequestration**

Sequestration, which refers to automatic cuts in the budgets of both defense and other discretionary federal programs, is one part of the Fiscal Cliff.

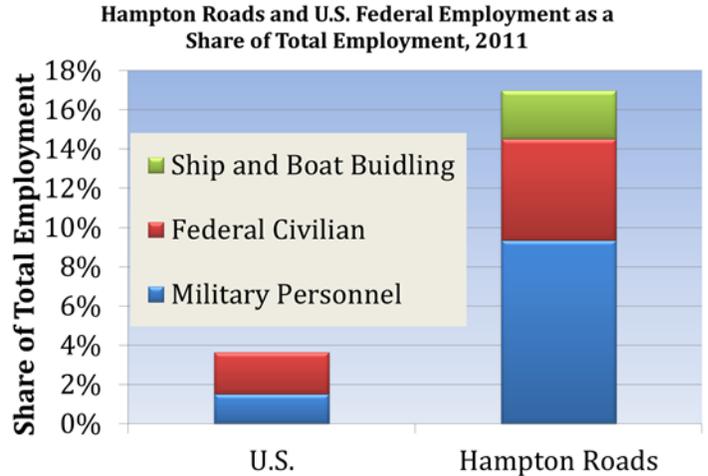
The Fiscal Cliff refers to the simultaneous implementation of sequestration along with the expiration of the payroll tax reduction as well as various tax cuts. The Congressional Budget Office projects that if no agreement is reached, the fiscal cliff will drive the nation back into recession.



**Sequestration's Impact in Hampton Roads**  
26,400 fewer jobs & \$1.9 billion less disposable personal income in 2014.

Source: Congressional Budget Office

As of 2011, approximately 17.0% of Hampton Roads employment was almost directly derived from federal dollars (ship and boat building includes repairs, which does some civilian work). The high multiplier associated with federal employment results in a federal contribution to the economy that far exceeds its direct employment. Current staff models suggest that Defense spending and employment alone contributed slightly more than 46% of the regional gross product in 2011. Given the size of the Federal presence in Hampton Roads, the impact of sequestration will clearly overwhelm any other economic dynamics in the regional economy.



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, HRPDC

**What Are the Possible Outcomes**

- 1) Sequestration could be postponed indefinitely or suspended through an agreement between the House, Senate, and the President before January 1st. The triggering of the sequestration mechanism immediately created uncertainty that damaged the economy, but an agreement would eliminate the uncertainty, and remove a large negative fiscal shock.
- 2) A deal postponing or canceling sequestration could be made early into the next congressional term after some of its effects have taken place. This would be akin to jumping off the fiscal cliff with a bungee cord attached; there would be a great deal of fear that would cause a large amount of disruption, but this would ultimately be a transitory event.
- 3) A deal could be put in place that would limit sequestration, but would still lead to large budget cuts to discretionary programs, particularly affecting defense. This result seems probable, as a compromise between deficit cutting in the short term and a desire to prevent a massive fiscal contraction that could send the nation into recession. The military particularly has argued that cuts need to be phased in over time, rather than the full cuts being made the first year of sequestration.
- 4) Lastly, Congress and the White House may not reach a deal on sequestration. This would lead to a combination of extreme damage to the local economy from defense cuts, with a recessionary national economy impairing this region's ability to grow other industries. A failure to reach an agreement on sequestration would have serious employment impacts at the national level, lowering the nation's employment by approximately 800,000. Additionally, failure to reach an agreement on the other elements of the fiscal cliff would send the nation back into recession.

**Potential Impact in Hampton Roads**

It is difficult to understate the magnitude of the impact of sequestration on the Hampton Roads Economy. However, using CBO estimates of sequestration's national impact (considered among the most conservative), HRPDC staff used the REMI model to conduct a dynamic economic analysis. This analysis indicates a large decline in regional income, with real personal

incomes declining throughout the decade to a full impact of \$1.47 billion of real disposable personal income lost in 2013 to \$1.58 billion by 2022. Regional employment would decline by 26,500 by 2014, but would begin to recover very slowly moving toward 2022, as lower wages would encourage other industries to move into the region. Still, over the next decade there would be 24,891 fewer jobs in Hampton Roads. The region would not return to its previous economic growth levels after this event but would recover to 2012 levels of employment by 2016, assuming that national growth returned to long term averages. Regional Gross Product would be \$3.06 billion on average through 2022. This would have a significant impact on population, as residents would leave the region in search of employment.

Year and Size of Sequestration Impacts in Hampton Roads		
Category	Average Annual Impact	Year of Greatest Impact
Total Employment	-24,891	2014
Gross Product	-\$3.06B	2014
Real Disposable Personal Income	-\$1.54B	2022

Source: HRPDC

Hampton Roads Economic Outlook: by James Clary

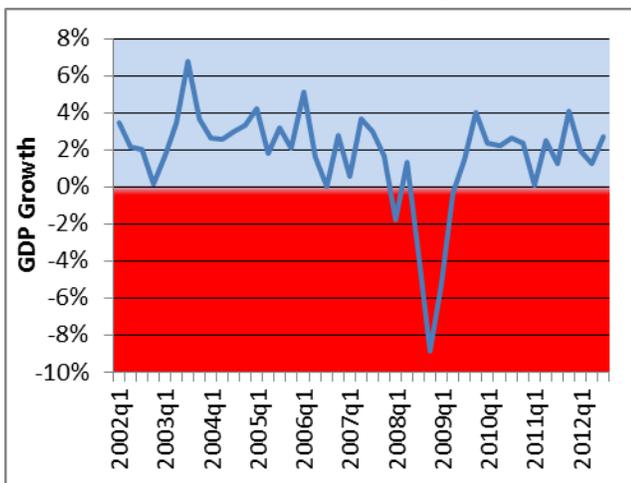
# Hampton Roads is Waiting

Hampton Roads continues to languish in an environment of uncertainty due to the fiscal cliff and sequestration. While U.S. GDP and regional retail sales have both experienced modest growth, employment remains weak. Uncertainty about the path of federal spending in this region leads businesses to hold off on investments and the expansion of payrolls until a clearer picture emerges. Anecdotally, larger contractors have stopped breaking up contracts and bidding out pieces to smaller firms because of concerns about future contracts. This is having an impact on firms of all sizes, but particularly small firms that have a smaller cushion to wait out the current political situation.

Typically, retail sales growth and increased fixed residential investment raise regional economies out of recessions. Unfortunately, neither of these two key drivers of economic expansion have exhibited robust growth. This suggests that economic growth in the near term will be driven by businesses investing in office space and staff in the region. Unfortunately, most small businesses and government contractors lack the confidence to begin that investment at this time.

## Hampton Roads Economic Indicators

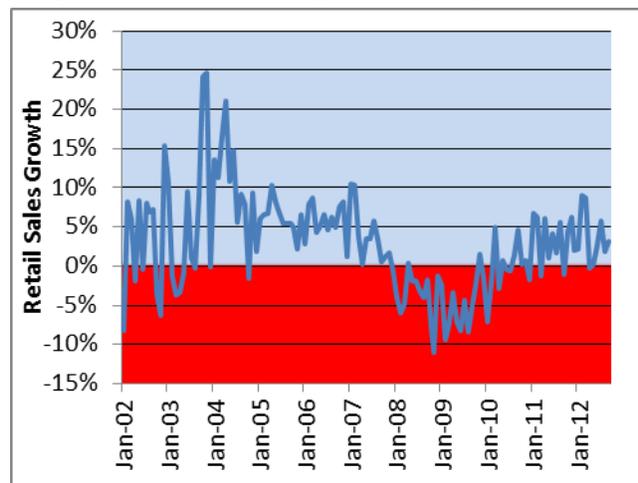
**GDP, Annualized Growth Rate**  
United States, 2002Q1 – 2012Q3, Quarterly



Source: Bureau of Economic Analysis, HRPDC

GDP: Gross Domestic Product combines consumption, investment, net exports, and government spending to determine the size and general health of the economy. U.S. gross product increased at a 2.7% annualized rate the third quarter of 2012. While not the catch-up growth that typically follows a recession, it is much closer to healthy economic growth than the nation experienced since the recession. Unfortunately, several of the underlying details were disappointing as personal consumption expenditures were weaker than first estimates indicated and increasing inventories created much of the GDP growth.

**Retail Sales, Year over Year Growth**  
Hampton Roads, Jan 2002 – Sep 2012, Monthly



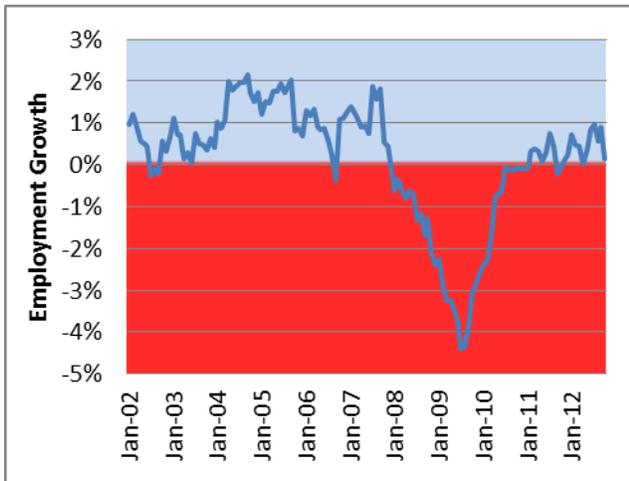
Source: Virginia Department of Taxation, HRPDC

Retail Sales: Retail sales, as measured by the 1% local option sales tax, serve as an indicator for consumption in the region. Since consumption composes 70% of economic activity in the US, the growth or decline of retail sales gives a strong indication of the direction of the local economy. Retail sales were up 3.1% between September 2011 and September 2012. While still 0.6% below the retail sales levels prior to the recession, this weak growth shows a modest recovery is ongoing in the region.

## Hampton Roads Economic Indicators

### Employment, Year over Year Growth

Hampton Roads, Jan 2002 – Oct 2012, Monthly

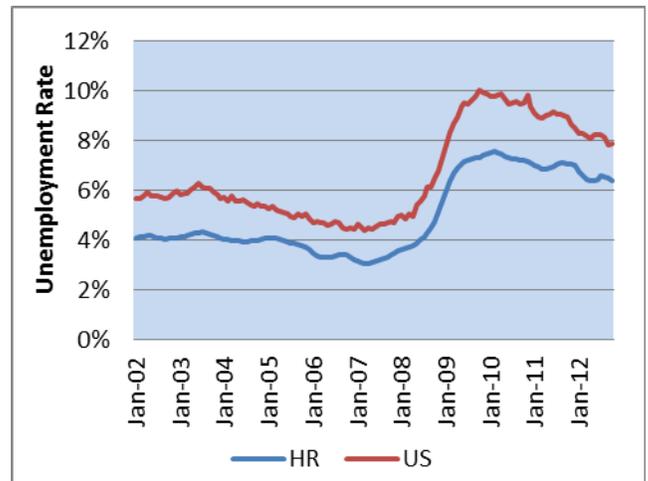


Source: Bureau of Labor Statistics, HRPDC

**Employment:** Non-agricultural employment is considered the best estimate of labor market activity by the National Bureau of Economic Research. While year-over-year employment remains positive, this obscures a large decline in seasonally adjusted payrolls during the past two months. Employment declined by a combined 8,300 positions in August and September of 2012, only recovering slightly in October (+1,100 payrolls).

### Unemployment Rate, Seasonally Adj.

U.S. & Hampton Roads, Jan 2002 – Oct 2012, Monthly

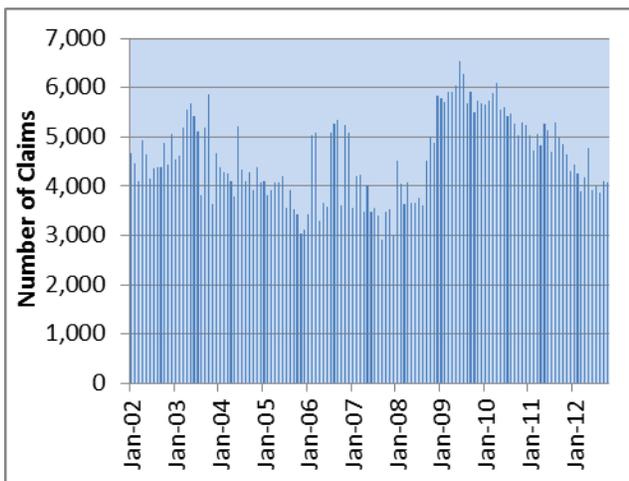


Source: Bureau of Labor Statistics, HRPDC

**Unemployment Rate:** The unemployment rate is the percentage of the population which is actively seeking work, but is unable to obtain a position. Hampton Road's unemployment rate was 6.37% in October 2012, the lowest level since February 2009 when unemployment was growing rapidly with the recession. The unemployment rate has declined in the region, but not as quickly as it is falling in the rest of the country.

### Initial Unemployment Claims, Seasonally Adj.

Hampton Roads, Jan 2002 – Oct 2012, Monthly

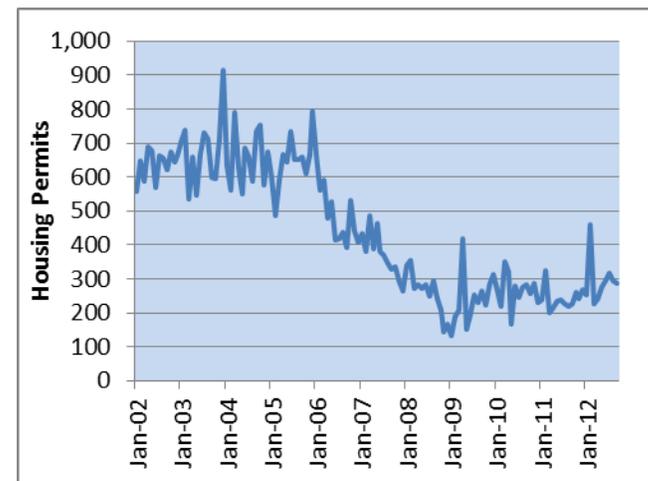


Source: Virginia Department of Labor, HRPDC

**Initial Unemployment Claims:** The number of Initial Unemployment Claims is a leading economic indicator, reflecting those who are forced to leave work unexpectedly and thus revealing the strength of the job market with little lag time. Initial claims have declined off the peak in the recession, and are now below the region's average. If there was significant tightening of the job market signaling a robust expansion, initial claims would decline below the long-term average.

### Single Family Housing Permits, Seasonally Adj.

Hampton Roads, Jan 2002 – Oct 2012, Monthly



Source: U.S. Census Bureau, HRPDC

**Single Family Housing Permits:** Permit data indicates the level of construction employment and confidence regarding the future trajectory of the local economy. An average of 289 permits have been issued over the past six months, 202 less permits per month than the long-term average. This decline in home building accounts for approximately 15,000 jobs lost over the past 5 years, half the job decline since October of 2007. While construction employment and building should increase, the impact will not drive economic recovery.