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James W. Hughes and Joseph J. Seneca, editors

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2006: Slow at the Close

By James W. Hughes and Joseph J. Seneca

In an economic environment of higher interest rates and volatile energy costs, accompanied by a significant deceleration in housing activity, employment growth slowed in both the United States and New Jersey through September 2006. Fortunately, energy prices declined significantly during the third quarter, increasing disposable income, boosting consumer confidence, and easing inflation. However, if the housing slowdown changes into a full-blown housing slump, then the full benefit of declining energy costs will be muted. So, as usual, uncertainty reigns. One positive for New Jersey is the formulation and implementation by the Corzine administration of a much-needed multidimensional economic growth strategy for New Jersey. This strategy will be examined following a review of the national and state economies, as well as the sliding housing sector.

The Nation

The national economic expansion reached 60 months in length in November, surpassing the 59-month average length of the 10 post–World War II economic expansions in the United States. So, while it is not yet time to call in the economic mortician, it should be recognized that the economy is now in the mature phase of the business cycle. It should also be recognized that expansions really don't have a natural life span: the Federal Reserve usually murders them. After 17 interest rate increases—in modest quarter-point increments—since June 2004, which raised the federal funds rate from 1 percent to 5.25 percent, the probability of that happening has risen.

In fact, the economy has already slowed significantly this year. After employment grew by an average of 2 million jobs per year in 2004 *(continued, page 2)*

New Jersey: Still A Good Place To Do Business?

By Sachiyo Asakawa

People with little knowledge about New Jersey may be surprised to learn that New Jersey is perceived as an "unfriendly place to do business" despite the fact that giant international companies select New Jersey as their regional or world headquarters locations. Large global companies across all sectors, adhering to the conventional real estate wisdom that stresses "location, location, location," recognize that New Jersey has it all. It boasts proximity to major metropolitan cities well connected by transportation systems and a fast-growing port. The state's highly educated labor force is a big plus. More than 20 Fortune 500 companies call New Jersey home. After some big moves, such as the French pharmaceutical giant Sanofi-Aventis's headquarters relocation to Bridgewater, New Jersey, and Citco Fund Services, the world's largest hedge fund administrator, to Jersey City, it is hard to believe that New Jersey would be regarded as an unfriendly place for business. *(continued, page 5)*

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and 2005—a level that will actually increase when payroll employment data revisions occur early in 2007—employment growth since March 2006 has fallen to an annual rate of just 1.4 million jobs. Gross Domestic Product (GDP) increased by 5.6 percent in the first quarter of 2006, but growth slipped to 2.6 percent in the second quarter and to 1.6 percent in the third (advance estimate). The below-trend performance in the second and third quarters is likely to continue through the final quarter of 2006 and into 2007. This national weakness will certainly be echoed in New Jersey.

While employment growth is positive in New Jersey, it is painfully slow and is not keeping pace with labor force growth.

New Jersey

Employment growth in the state has been disappointing so far in 2006 and, in contrast to the nation's declining unemployment rate, New Jersey's unemployment rate has been increasing. During the last two expansions—the 83-month-long 1982 to 1989 expansion and the 103-month-long 1992 to 2000 expansion—annual employment growth averaged 77,000 jobs per year. But the current New Jersey expansion—50 months long as of September—has not yet come close to approaching that annual pace of growth (figure 1). For example, in 2004 and 2005, when the nation's job creation machine was running on all cylinders, New Jersey was adding, on average, 40,000 jobs per year, just barely over one-half of that expected. And, during the first nine months of 2006, the state failed to achieve even this modest pace of growth. New Jersey grew at an annualized rate of only 27,000 jobs in 2006, just one-third of that expected.

Only two of the 50 states had statistically significant unemployment rate *increases* between September 2005 and September 2006. Unfortunately, New Jersey was one of the two. The state had the highest unemployment rate increase (0.8 percent), rising from 4.4 percent one year ago to 5.2 percent this past September. The other state having a statistically significant increase was Michigan (0.6 percent), hard hit by automobile production cutbacks.

During the first three quarters of 2006 (December 2005–September 2006), New Jersey ranked 42nd among the 50 states in the rate of *private-sector* job growth (0.4 percent), lagging behind such economic powerhouses as Alabama, Kentucky, Tennessee, and West Virginia. For perspective, private-sector employment in the nation expanded by 1.0 percent during the first three quarters of 2006. So, while employment growth is positive in New Jersey, it is painfully slow and is not keeping pace with labor force growth.

One result is that the state has fallen from a ninth-place ranking in total employment among the 50 states to tenth place. In April 2006, Georgia surpassed New Jersey and is now ranked ninth. If current trends continue, North Carolina will surpass New Jersey in about two years (late 2008). Then, for the first time in its history, New Jersey will drop out of the top 10 states with the highest employment levels.

The structure of New Jersey's 2006 (December 2005–September 2006) employment growth is detailed in table 1. Of the 20,000 total job increase, nearly three-quarters (73.5 percent, or 14,700 jobs) was in the private sector, while one-quarter (26.5 percent, or 5,300 jobs) was in government. Since government currently (September 2006) accounts for 15.9 percent of total employment (647,700 jobs out of 4,084,500 jobs), its share of growth is significantly higher.

In a positive for the office market, professional and business services had the largest employment gain (8,200 jobs), although a significant share of this sector was in administrative support personnel. The other two sectors of importance to the office market had mixed results. The information sector (which includes telecommunications, publishing, and Internet service providers) lost 3,100 jobs, while financial activities (which includes traditional banking and advanced financial services) gained only 900 jobs. Thus, current employment growth alone has not provided a significant boost to the state's office markets.

New Housing Realities

In 2006, all measures of housing activity headed down in both the United States and in New Jersey. This followed an extended period of extraordinary housing production, housing sales, and housing price gains, which provided a sustained and powerful boost to the economy. Between 1998 and 2006, house

TABLE 1
Year-to-Date
New Jersey Nonfarm Payroll Employment
December 2005–September 2006
(Seasonally adjusted; numbers in thousands)

	December 2005	September 2006	Change: Number	Change: Percentage
Total Nonfarm	4,064.5	4,084.5	20.0	0.5
Total Private Sector	3,422.1	3,436.8	14.7	0.4
Goods-Producing	496.0	489.0	–7.0	–1.4
Natural Resources and Mining	1.8	1.9	0.1	5.6
Construction	171.0	171.8	0.8	0.5
Manufacturing	323.2	315.3	–7.9	–2.4
Private Service-Providing	2,926.1	2,947.8	21.7	0.7
Trade, Transportation, and Utilities	884.9	884.7	–0.2	0.0
Information	97.1	94.0	–3.1	–3.2
Financial Activities	283.3	284.2	0.9	0.3
Professional and Business Services	596.8	605.0	8.2	1.4
Educational and Health Services	565.9	573.7	7.8	1.4
Leisure and Hospitality	339.5	345.4	5.9	1.7
Other Services	158.6	160.8	2.2	1.4
Government	642.4	647.7	5.3	0.8

Note: North American Industry Classification System (NAICS) employment sectors.
Source: New Jersey Department of Labor.

A deceleration in housing activity has acted as a drag in 2006, subtracting from economic growth in both the nation and New Jersey.

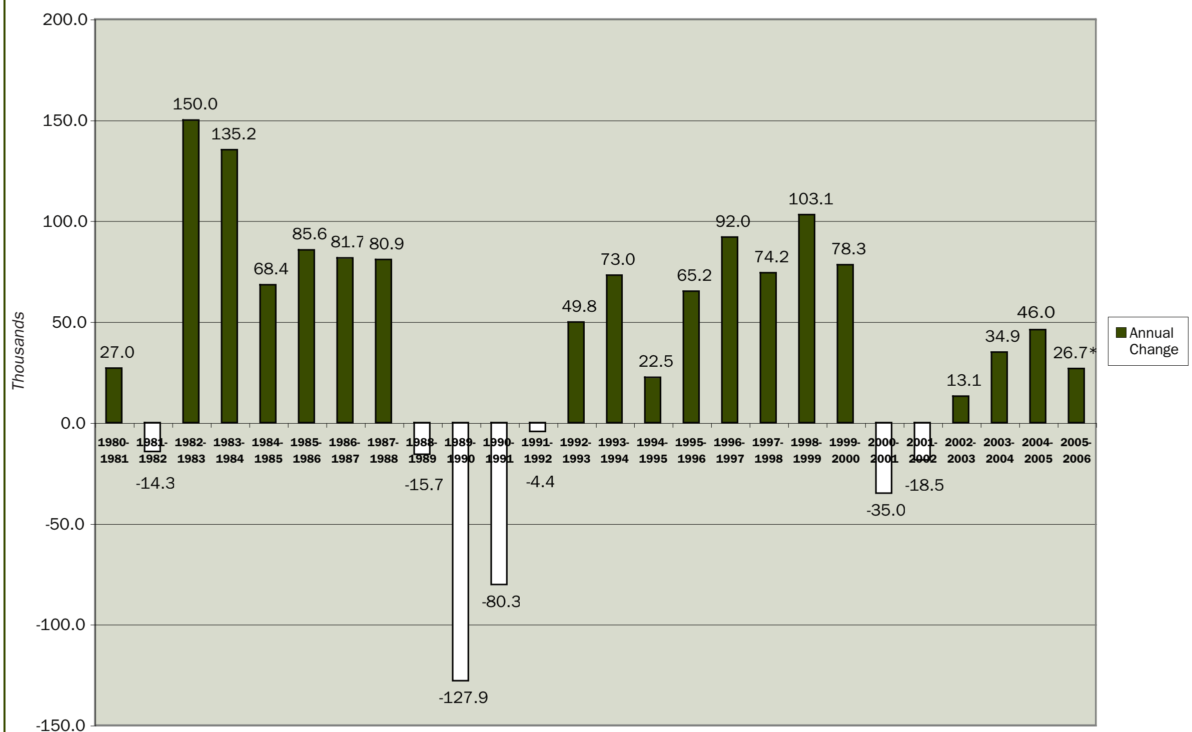
prices nationally increased by 91 percent, based on the housing price index of the Office of Federal Housing Enterprise Oversight (OFHEO). In New Jersey, they increased by 131 percent, for a compound *annual* rate increase of 10.7 percent! This greatly increased the wealth position of many New Jerseyans and provided strong support to the consumer economy. But this has now come to an end.

There are three areas of concern from the housing slowdown. First, a deceleration in housing activity has acted as a drag in 2006, subtracting from economic growth in both the nation and New Jersey. Second, if a severe and prolonged housing slump materializes, this will weigh heavily on consumer spending, negatively impacting all sectors of the economy. Third, the especially large increase in house prices in New Jersey that accompanied the boom has decreased the affordability of housing, and this contributes to the declining cost competitiveness of the state.

According to the Census Bureau's 2005 American Community Survey (ACS), New Jersey still had the highest median household income in the United States, ranking first among the 50 states. However, New Jersey also ranked first in housing costs (median monthly housing costs for *(continued, page 4)*

Competitor states often cite their much lower housing costs as a significant business and economic advantage.

FIGURE 1
New Jersey Total Nonfarm Employment
Annual Change (December to December), 1980–2006*



*2005–06 employment change forecast based on the first nine months of 2006.

owner-occupied housing units with a mortgage). While New Jersey household incomes are 33 percent higher than those of the nation, the state's monthly housing costs are 50 percent higher. So, about half of New Jersey's income advantage is being consumed by much higher housing costs. This is certainly not a positive for business cost competitiveness, and competitor states often cite their much lower housing costs as a significant business and economic advantage.

What To Do? New State Directions

The New Jersey economy, despite its high income, high wealth, and high employment profile, is an economy at risk, and it is located in a region at risk. Intensifying global competition, intensifying competition for high-end business among the states, and the general high cost of doing business—labor, land, taxes, and regulation—have placed the entire Northeast region at risk.

Thus, Governor Jon Corzine's Economic Growth Strategy to improve the performance of the state's economy, announced in September 2006, could not have been more timely or more important. The Strategy is a multidimensional plan to increase private-sector employment and investment in New Jersey. This is truly a unique effort in the history of the state.

Of particular note, the Governor's Growth Strategy establishes the Edison Innovation Fund, with potentially $500 million in state and private resources for strategic investments in science and technology. The scale of this *(continued, page 8)*

Stable Market Persists

by Sachiyo Asakawa; Greg Nowell, Senior Vice President; and Christopher Santoro, Assistant Vice President

The New Jersey office market is known for its stability, and the third quarter of 2006 clearly proved it, despite some concerns about a slow summer and escalating gas prices at the end of the last quarter. The vacancy rate for the third quarter was 15.8 percent, almost unchanged from the previous quarter, and the average asking price rose slightly, from $25.06 to $25.14. Overall net office market absorption was positive — +52,907 square feet, making for three consecutive quarters with positive absorption this year. Industry professionals observed a flurry of activity in the marketplace, with potential tenants inspecting office spaces and many of them finalizing transactions for the end of this year and early 2007. There was also a noticeable upswing in the number of tenants expanding and upgrading from Class B to Class A facilities.

Underlying this consistent activity, a trend observed by industry professionals is that of generous incentives offered by landlords in their attempt to entice tenants to lease empty prime Class A office space. Despite this trend, the Route 287 submarket, which includes Piscataway, South Plainfield, and Somerset, continues to show very limited absorption, even with landlord incentives. Conversely, Metropark and the surrounding submarkets continue to show positive absorption.

Significant transactions in the marketplace have taken place on the Jersey City waterfront.

Significant transactions in the marketplace have taken place on the Jersey City waterfront, with two financial giants leasing a total of approximately 600,000 square feet of Class A space. Citigroup sublet approximately 317,000 square feet from UBS PaineWebber at Newport Office Center VII, relocating 1,500 employees from its *(continued, page 6)*

Still A Good Place?, continued

In reality, the business climate in New Jersey worsened during the 2001–2005 period. By 2006, the Tax Foundation had ranked New Jersey's business tax climate 48th among the 50 states. Fortunately, as detailed in another article in this report, the state is finally addressing this issue. While the state's sales tax has increased to 7 percent, equal to the highest rate in the nation, there were two major business tax cuts in the FY 2007 state budget that total approximately $350 million.

After stagnation in the state's economy in the 2000–2003 period, and its subsequent fallout in the office market, New Jersey's office market appears to be in recovery. But there are still problems. Formerly the nation's "medicine chest," the state's pharmaceutical industry has not experienced any employment growth so far in this decade. New Jersey's crucial biotech industry is facing enormous competitive pressures from other states. Even Las Vegas, Nevada, is attempting to recruit biotech companies out of New Jersey. At the same time, some mid-sized manufacturing companies have relocated their East Coast distribution hubs from New Jersey to the growing ports in the South, such as Savannah, Georgia, to avoid New Jersey's high operating costs.

Businesses are increasingly cost sensitive, and New Jersey is a high-cost place to carry out economic activity. Left unaddressed, this will reduce New Jersey's historical advantage as one of the nation's best geographic locations for doing business. Fortunately, the problem is starting to be addressed in Trenton. ■

Continuing the pattern from last quarter, the Hudson waterfront market experienced very strong sublease activity.

Northern and Central New Jersey Total Office Market
Third Quarter 2006

			DIRECT		TOTAL (Direct and Sublet)				
County	**Buildings**	**Total Inventory**	**Space Available**	**Vacancy Rate**	**Space Available**	**Vacancy Rate**	**Average Asking Rent**	**QTD Net Absorption**	**2006 YTD Net Absorption**
Bergen	565	29,284,693	3,895,891	13.3%	4,753,205	16.2%	$26.54	(517,458)	(423,472)
Essex	394	28,793,953	3,201,963	11.1%	3,447,948	12.0%	$24.61	(27,557)	141,892
Hudson	165	23,498,868	2,216,742	9.4%	3,287,300	14.0%	$29.15	(313,565)	732,733
Hunterdon	52	1,775,254	313,886	17.7%	370,601	20.9%	$24.67	17,899	(1,020)
Mercer	338	16,080,351	2,105,139	13.1%	2,305,955	14.3%	$24.35	56,970	86,101
Middlesex	455	26,784,268	4,597,727	17.2%	4,953,865	18.5%	$24.22	561,800	639,721
Monmouth	408	15,011,469	1,396,395	9.3%	1,544,805	10.3%	$21.69	(77,397)	(64,769)
Morris	428	29,542,160	5,641,112	19.1%	6,010,486	20.3%	$26.49	84,397	171,689
Passaic	160	6,520,984	1,049,916	16.1%	1,091,473	16.7%	$23.28	7,719	(99,850)
Somerset	272	19,439,616	2,988,407	15.4%	3,974,520	20.4%	$23.75	256,087	289,401
Union	311	11,566,579	936,653	8.1%	1,196,139	10.3%	$24.59	4,012	215,415
Total	**3,548**	**208,298,195**	**28,343,831**	**13.6%**	**32,936,297**	**15.8%**	**$25.14**	**52,907**	**1,687,841**
Central NJ	1,784	88,882,283	12,024,321	13.5%	13,975,284	15.7%	$23.72	801,472	1,165,869
Northern NJ	1,764	119,415,912	16,319,510	13.7%	18,961,013	15.9%	$25.79	(748,565)	521,972

Notes: Includes all office buildings, 10,000 square feet and greater. Does not include owner-occupied facilities. Total Vacancy, Space Available, and Net Absorption figures are in square feet.

Manhattan downtown office. At Harborside Financial Center I, Deutsche Bank renewed its 90,000-square-feet lease and added 138,193 square feet in order to consolidate several operations in the metropolitan area. Continuing the pattern from last quarter, the Hudson waterfront market experienced very strong sublease activity. As a result, the total vacancy rate dropped from 16 percent in the fourth quarter of 2005 to 12.5 percent at the end of this quarter. The vacancy rate in the sublease market declined almost in half from that of last year—from 8 percent to 4 percent. This very active leasing in the market seems to be strongly related to the recent rent hike in the Manhattan office market. The Jersey City waterfront has become the destination of choice as Manhattan rents have escalated at a rapid pace over the past

Northern and Central New Jersey “Class A” Office Market
Third Quarter 2006

County	Buildings	Total Inventory	DIRECT Space Available	DIRECT Vacancy Rate	TOTAL (Direct and Sublet) Space Available	TOTAL (Direct and Sublet) Vacancy Rate	Average Asking Rent	QTD Net Absorption	2006 YTD Net Absorption
Bergen	78	12,823,401	1,964,859	15.3%	2,621,371	20.4%	$29.19	(257,080)	(369,714)
Essex	62	15,124,287	1,789,787	11.8%	2,019,992	13.4%	$27.09	(100,644)	41,179
Hudson	48	19,117,785	1,832,020	9.6%	2,886,848	15.1%	$30.69	(346,406)	668,028
Hunterdon	6	762,030	200,978	26.4%	248,705	32.6%	$26.59	6,630	17,469
Mercer	68	7,089,327	1,071,146	15.1%	1,172,886	16.5%	$26.70	70,760	(49,874)
Middlesex	114	15,998,781	3,141,122	19.6%	3,273,019	20.5%	$25.85	597,468	787,472
Monmouth	51	5,886,088	311,621	5.3%	370,562	6.3%	$25.94	(20,321)	(35,570)
Morris	122	18,725,768	4,465,214	23.8%	4,781,788	25.5%	$27.68	109,145	126,951
Passaic	15	1,859,290	564,857	30.4%	576,867	31.0%	$25.80	(80,615)	(164,916)
Somerset	100	14,074,533	2,223,247	15.8%	3,183,542	22.6%	$24.16	242,158	327,652
Union	30	3,851,174	360,143	9.4%	607,362	15.8%	$28.52	3,692	253,358
Total	**694**	**115,312,464**	**17,924,994**	**15.5%**	**21,742,942**	**18.9%**	**$26.99**	**224,787**	**1,602,035**
Central NJ	363	46,899,903	7,107,279	15.2%	8,607,371	18.4%	$26.23	893,757	1,283,038
Northern NJ	331	68,412,561	10,817,715	15.8%	13,135,571	19.2%	$27.84	(668,970)	318,997

Notes: Includes all office buildings, 10,000 square feet and greater. Does not include owner-occupied facilities. Total Vacancy, Space Available, and Net Absorption figures are in square feet.

We predict that “Jersey Flight” will continue if Manhattan rent continues to rise.

quarters. We predict that “Jersey Flight” will continue if Manhattan rent continues to rise, as is expected.

Monmouth County has a total 2.05 million square feet of office space under construction at the end of the third quarter. Strong demand in that market continues, contributing to the low vacancy rate of 10.3 percent at the end of the quarter.

Consistent leasing activities in the market usually range between 3,000 and 5,000 square feet. Although larger blocks of spaces continue to be delivered and leased by larger tenants, industry professionals expect that landlords will continue to divide up larger units to accommodate the current trend toward smaller spaces and offer incentives to fill unleased facilities. ■

investment and the targeted use of the considerable resources of the Fund will position New Jersey well in the competition with other states for this highly contested, and vital, component of economic development. The science and technology industries are critical to New Jersey since they generate a significant share of their revenues from sources external to the state as well as the country. Such revenues, brought into New Jersey, generate sizeable new net income, jobs, and investment with associated multiplier effects and increase both the absolute and relative economic growth of the state.

The Edison Innovation Fund proposed by the Governor appropriately relies on decision making and collaboration between three key state agencies. The New Jersey Economic Development Authority, with its considerable experience in effectively supporting commercial activity, will make loans and investments in specific business ventures. The New Jersey Commission on Science and Technology will apply its systematic peer-review process to invest in strategic scientific areas to build research capacity at the state's research universities in collaboration with targeted private-sector economic growth. The Commission on Higher Education will advise on investments in the research capacities of the state's universities.

The Governor's plan importantly also includes more coordinated and strategic use of existing capital investment in public infrastructure by state agencies and authorities. In addition, it proposes a $555 million New Jersey Urban Fund of public and leveraged private resources to maintain the competitiveness of the state's urban areas and related assets, such as ports and the state's multimodal transportation network.

In addition, recent tax changes included in the state fiscal year 2007 budget also signal that economic growth is a major priority for the Corzine administration. Despite the state's difficult fiscal problems, two key business tax changes have substantially improved New Jersey's business climate. First, the alternative minimum corporate tax was eliminated, and with it the burden of requiring businesses to pay a tax that is not based on earnings. Second, the ability of businesses to carry losses forward to offset future tax liabilities was fully restored. This is a key tax code feature used by many states, and it is especially important for small, emerging science and technology businesses. Together, these changes represent an approximately $350 million state investment in supporting economic development.

Finally, and most important, are Governor Corzine's strong statements in his discussion of the Economic Growth Strategy. He has assumed the lead responsibility for promoting New Jersey to the business community and has provided assurance that the state's commitment will be sustained over time and backed by action. This single, highly visible message of economic leadership from the chief executive of New Jersey, pledging that growing the state's economy is the top priority of the administration, provides the vital signal of certainty and action so important to the worldwide business community. ■

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