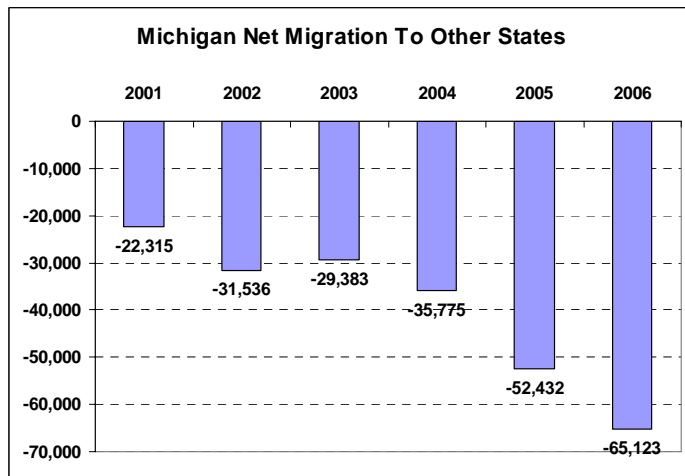
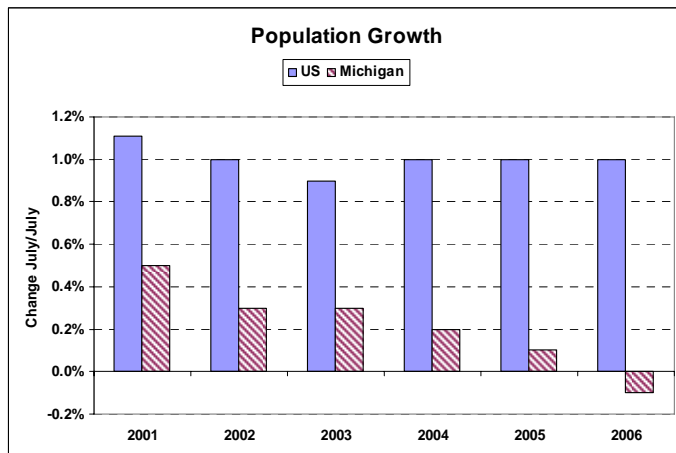


No Better, No Worse

People in Michigan are reacting to its difficult economic climate by voting with their feet. From mid 2005 to mid 2006, 65,000 more people moved out of Michigan than moved into it from other states. That was almost a three fold increase compared to 2001. Michigan's rate of net out-migration ranked 8th among the states in 2006. Back in 2001, it ranked only 20th.

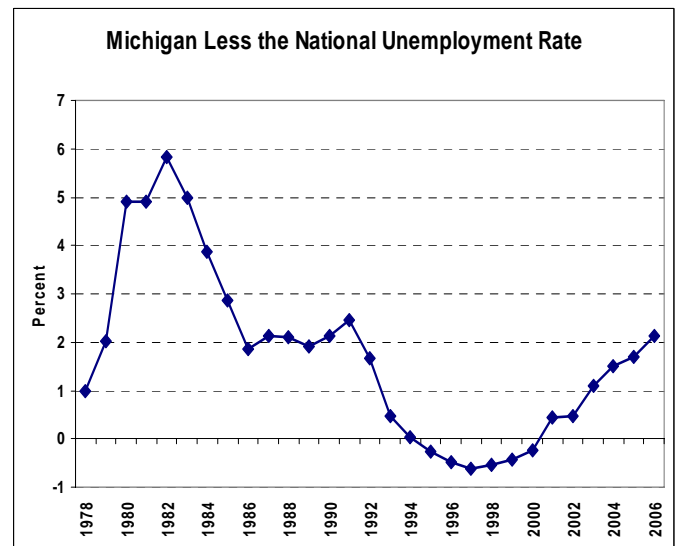


Reflecting mostly the accelerating pace of out-migration, Michigan's population growth has slipped from slow to none. Indeed, for the first time since 1982 and 1983, the state's population declined in 2006. From July 2005 to July 2006, it edged down by 5,000 or 0.1 percent.



A good way to quantify Michigan relative economic performance is the gap between its unemployment rate and the national average. As the chart below shows, that differential averaged 2.1 percentage points in 2006, which was the widest in 15 years. Even so, the gap was not nearly as wide last year as it was in the early 1980s when the Fed's efforts to deal with double-digit inflation produced sky-high interest rates and a severe recession in the auto sector.

Michigan's unemployment rate peaked at 16.9 percent in 1982 and the differential with the U.S. rate averaged almost 6 percentage points that year. With the local economy in disarray, the state saw its population drop by 97,000 (1.0%) in 1982 and another 67,000 (0.7%) in 1983. Population growth in Michigan did not return to normal until 1986 when the jobless rate differential had dropped back to around 2 percentage points.



While last year's drop in population in reaction to the state economic woes echoes the episode in the early 1980s, there are important differences. Soaring unemployment in Michigan in the early 1980s was part of a broader national recession. As is typical, Michigan suffered more than the nation because of its

concentration of cyclically sensitive manufacturing companies, particularly autos.

What Michigan is in the midst of now is more of a one-state recession caused by structural not cyclical problems in its auto sector. To be sure, the country is in the midst of a mid-cycle correction in which growth has slowed to a below-trend pace. But unit sales of light vehicles declined only 2 percent in 2006. What slammed the state is that the Michigan-based auto companies saw their sales of light vehicles decline by 8 percent. With the market share of the Big 3 now down 12 percentage points over just the past six years, all three companies are losing huge sums of money. All three are scrambling to restructure themselves in an urgent effort to return to profitability.

Total vehicle sales may strengthen later this year, if as I am forecasting, the drag from homebuilding subsides. But so far, there is no sign that the Big 3 have been able to stabilize much less recover any of their lost market share. Indeed, all three companies are permanently closing factories and offering buyouts to salaried and hourly workers, thereby acknowledging that they expect a lasting decline in their market share. The implication is that none of the companies expects a snap back in production, employment, and profitability similar to those seen in the early stages of past business cycles.

Employment in auto and auto parts manufacturing in Michigan declined by 25,000 last year. Remarkably, employment in other Michigan industries showed a net increase of 5,000. The resilience of these other sectors strongly suggests that the state will begin to perform noticeably better soon after the headwind from autos begins to subside. Unfortunately, there is no sign of a let up in job losses in the auto sector. Buyouts at Ford, Chrysler, and their suppliers could easily cut another 25,000 jobs from Michigan payrolls in 2007.

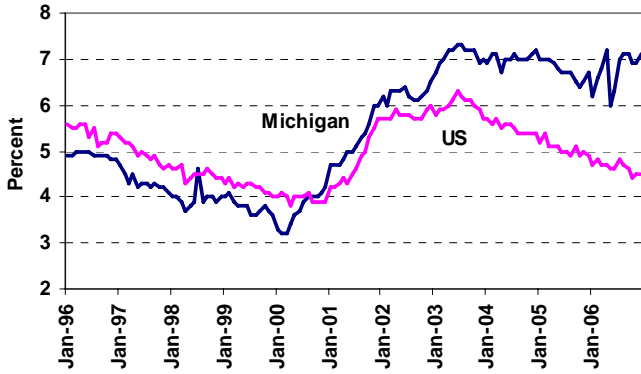
The key takeaway is that the Michigan economy will continue to under perform in 2007 due mainly to the restructuring of the auto manufacturing sector. The state's unemployment rate probably will average about 2 ½ percentage points above the national rate. And the state's population probably will decline for a second straight year as a sizable number of citizens decide to pursue their careers elsewhere.

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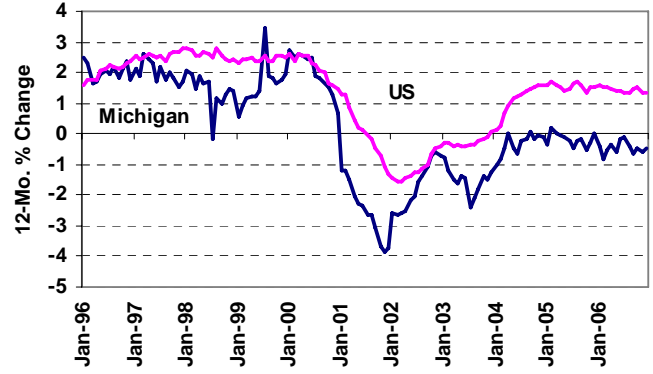
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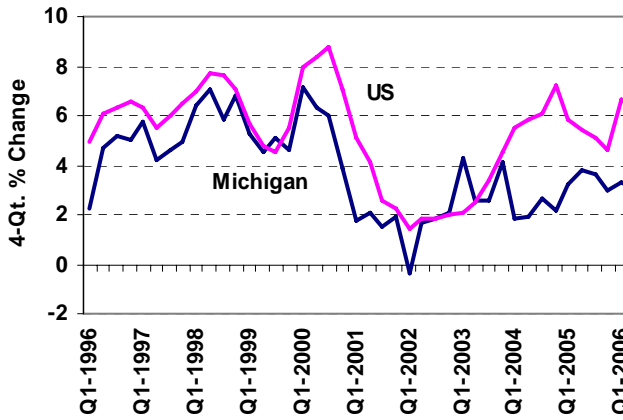
Unemployment Rate



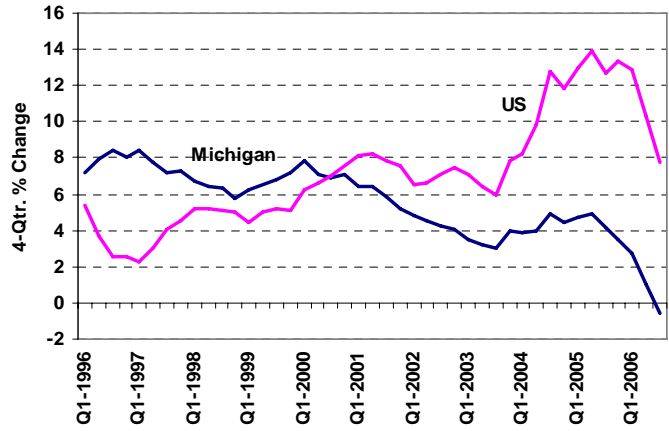
Nonfarm Payroll Employment



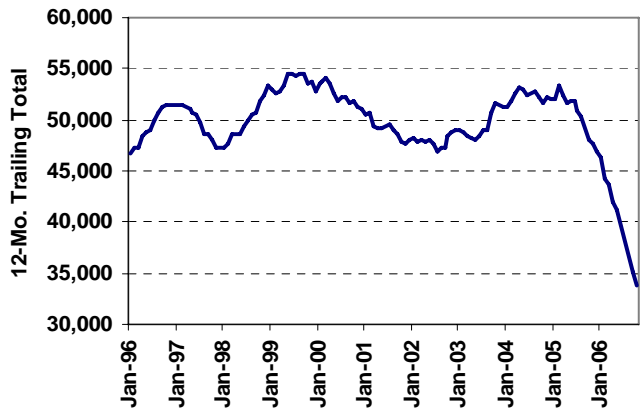
Personal Income



OFHEO House Price Index



Residential Building Permits



Real Gross State Product

