

Employment, Real Estate Slump Keep California Behind National Economy

U.S. Economy Slows Abruptly

The economic statistics seemed to deteriorate along with the headlines and the financial markets over the last three months. In particular, growth in U.S. gross domestic product (GDP) slowed sharply from a sparkling 4.9 percent annual rate in the third quarter to just 0.6 percent annual rate during the fourth quarter. A decline in business inventories and the continued plunge in new home construction each subtracted about 1.2 percentage points from GDP growth.

Elsewhere, consumer spending grew at a 2 percent annual rate, while purchases of equipment and software increased at a 3.8 percent annual rate. Net exports continued to improve, though the improvement came via minimal import growth, as export growth slowed to a 3.9 percent annual rate from the extraordinary 19.1 percent in the previous quarter.

As shown in the chart, the slowdown is real, but less dramatic if we take a somewhat longer view. Domestic demand, which excludes changes in inventories and net exports, grew by 1.9 percent last quarter compared with the fourth quarter of 2006, just a bit slower than the 2.1 percent increase of the previous quarter.

There has been other disappointing news. Monthly increases in non-farm payroll employment, which averaged 107,000 net new jobs during the first six months of 2007, dropped to just 82,000 net new jobs during the last six months of the year. Worse, the preliminary figure for January 2008 was negative 17,000 jobs.

Since midyear, weakness has spread from residential construction to manufac-

U.S. Domestic Demand



turers and distributors of housing-related products (doors, windows, shingles, furnaces, etc.), to the financial sector. It first hit mortgage finance and then more broadly to Wall Street and beyond.

Employment growth has slowed in other industries as well, reflecting an abundance of employer caution. The nation's unemployment rate, meanwhile, moved up from 4.6 percent in June to 5 percent in December, before edging down to 4.9 percent in January.

Consumer sentiment has dropped markedly, despite moderate growth in real disposable income — up by 2.1 percent in the 12 months to December. Consumer sentiment usually reflects labor market conditions and recent trends on the inflation front.

The latter are problematic. Energy prices are reaching for new highs, with crude oil testing at \$100 per barrel, and gasoline prices soaring. The increase in grocery prices has been just as conspicuous. Consumers have been the mainstay of the U.S. economy in recent years, but both of these prices limit consumers' discretionary spending.

Concerns about a possible recession increased as the data worsened. Virtu-

ally all economic forecasters recently reduced their economic forecasts for 2008, with some now expecting a shallow downturn (in GDP terms) early in the year.

The Economic Advisory Council shares these concerns, noting the odds of a downturn have risen to perhaps 50-50. However, the steep production and employment declines that usu-

ally accompany a recession have thus far been confined to specific industry sectors — housing, manufacturing and finance. Outside of these sectors, the economy is doing reasonably well.

Interest Rates/ Financial Markets

The Federal Open Market Committee (FOMC) dropped its fed funds target rate in several steps from 5.25 percent in August 2007 to 3 percent at its January 2008 meeting, a swift decline not seen since the 2001 recession. The Fed was motivated by two concerns: an upsurge of extreme instability in global financial markets and fears that the volatility could spread to the real economy, bringing on a recession.

Global credit markets “seized up” in August. Market participants grew increasingly alarmed about the impact of rapidly growing mortgage defaults on the credit quality of derivative instruments containing the bad mortgages and the “credit-worthiness” of financial institutions holding those instruments. Market liquidity began to evaporate, first for various types of mortgage-related securities,

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and then for the financial institutions.

To calm things down, the Federal Reserve and other central banks flooded their respective capital markets with funds and made special lending facilities available to institutions that needed cash to build reserves.

But things haven't calmed down yet. Credit markets still get "the jitters" periodically, especially when new data are released about declining home

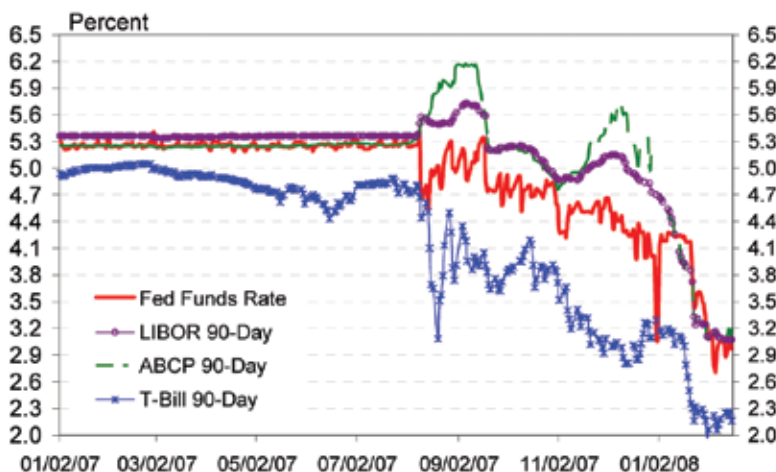
sales, rising loan delinquencies or when financial institutions announce they have to take large write-offs to reflect the lower value of their mortgage or mortgage-backed portfolios.

The latest survey of senior bank lending officers — taken in January — indicates that the nation's large lending institutions have grown much more cautious about taking on more risk. A significant fraction of banks reported tightening credit standards and boosting terms, not just for residential mortgages (as might be expected), but also for commercial real estate loans and regular consumer and business (commercial and industrial) loans. This attitude is a special concern in California, which has a large base of credit-dependent small and medium-sized businesses.

This new, stricter attitude is a matter of some concern to the Federal Reserve Board, because bank lending is one of the more important channels through which monetary policy works. U.S. policy is currently focused on preventing an economic downturn and stabilizing capital markets.

Toward these ends, the council believes the Fed's target fed funds rate may well have to be reduced further. However, the Fed's field of action will be constrained if inflation does not moderate as anticipated. Once some degree of normality returns to credit markets and to the real economy, the

Short-Term Interest Rates



Fed is likely to raise the target fed funds rate back toward neutrality to avert an upsurge of inflation.

State Economy Underperforms

California has been underperforming the rest of the United States by most economic indicators, largely due to fallout from housing-mortgage problems. Non-farm employment, for example, increased by just 0.4 percent over the year to December 2007 (using the "Interim Series," which hints at the upcoming revisions to the official data released for 2006 and 2007), while employment in the nation grew by 0.8 percent over the same period.

The pattern was similar between December 2005 and December 2006, though growth was higher in both cases, with the United States recording a 1.6 percent increase in payroll employment while California registered 1.1 percent.

Much of the California slowdown in employment growth during 2007 came in the construction, real estate, mortgage-related financial and manufacturing sectors, all of which reduced head counts during 2007. On the plus side, job growth leaders included education and health, with payrolls up by 4 percent (again using the Interim Series), leisure and hospitality (+2.3 percent), and professional, scientific and technical services (+2.1 percent).

However, layoffs in construction, manufacturing and finance helped boost the state's unemployment rate from 5.2 percent in June to 6.1 percent in December. This was a bigger increase than experienced by the U.S. jobless rate, so the margin between the state and the nation widened from 0.6 percent to 1.1 percent.

Exports of goods made in California are providing much-needed strength to the state's economy. Total

state exports grew by 5 percent during 2007 — a solid performance, though not as strong as in 2006.

The largest category of exports is high tech manufactures (computers and electronic products), which declined slightly — by -1.9 percent — in dollar terms last year after growing by 6.7 percent the previous year. Similarly, exports of non-electrical machinery fell by -2.8 percent after surging by 13.2 percent in 2006. Exports of transportation equipment grew by a modest 1.9 percent.

However, exports of other important California-made products were strong, with chemicals up by 20 percent, miscellaneous manufactures up by 15.1 percent, and agribusiness products (farm produce, livestock, fish and processed food products) rising by 9.4 percent.

Only three-quarters of personal income data have been released as of this writing. Personal income earned in California increased by 6 percent during the first three quarters of 2007 compared to the same period in 2006. U.S. personal income grew by 6.3 percent over the same period.

More recent California information can be inferred from state personal income tax payments. The State Controller reports that personal income tax receipts increased by 4.3 percent during the first seven months of the 2007-08 fiscal year (July 2007 through January 2008),

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From Previous Page compared with the same period the previous year, suggesting that income growth has slowed. Further, Department of Finance reports show that income and sales tax receipts have been running below expectations.

Regional economic performance is mixed, depending in part on the importance of the residential- and mortgage-related industries to the local economy, and in part on how the rest of the economy is doing. Using preliminary (not yet revised) estimates, non-farm employment growth between December 2006 and December 2007 was most rapid in the Riverside-San Bernardino areas, Bakersfield and Fresno, followed by San Francisco/San Jose.

At the other end of the scale, employment declined in the Stockton area and in Orange County over the course of 2007.

(Note: It would not be a surprise if employment in many metro areas is revised downwards. However, the rank order shown in the chart should still be appropriate.)

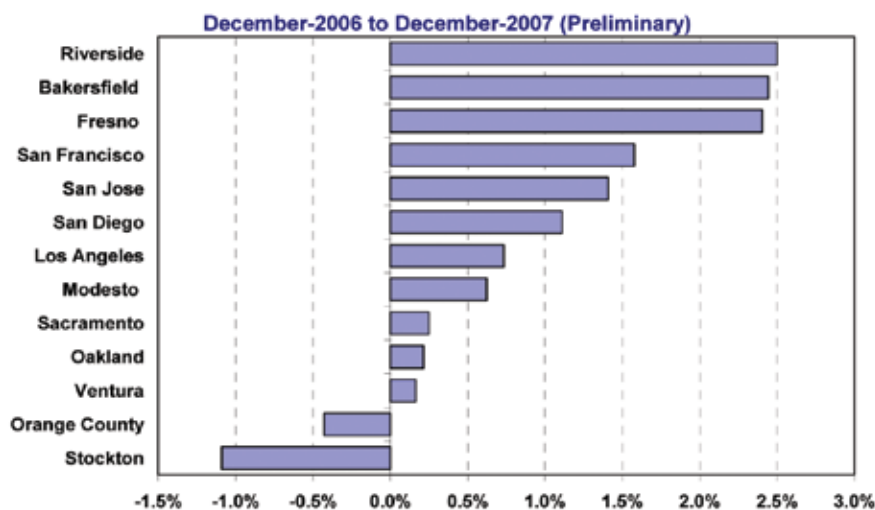
The San Francisco Bay area continues to outperform other regions of the state. In large part this reflects the renewed strength of the high tech sector, where employment is rising nicely.

In addition, the biotech sector continues to develop, and tourism-related activities are doing well. However, construction is shrinking in the Oakland/Contra Costa areas, and finance industry jobs have disappeared, especially in Oakland and San Francisco.

In Southern California, the motion picture industry might return to normal now that the writers' strike has ended. However, negotiations with the Screen Actors Guild have not yet started, so the path to a full recovery is not clear.

Residential construction is very soft throughout the region, with a marked

Non-Farm Payroll Employment Growth



slowdown in new homebuilding in the Inland Empire. Also, Orange County has taken substantial hits in its mortgage banking industry. San Diego's economy is being led by growth in tourism, education, health care, biotech and aerospace. In Los Angeles, the strongest industries are tourism, technology and professional business services.

Agriculture and Resources

California's agriculture sector is holding up well. Prices are high for most products and exports are growing nicely. Costs also are rising, however, especially feed grains for livestock and energy of all types.

Profitability varies widely by product. As examples, dairy and nut producers are doing well, but cattle and poultry margins have been squeezed. In January, the minimum wage was raised, and as a result, farms will experience higher labor costs as well in 2008.

A number of farms in California will have to make hard decisions in 2008 about which products to produce, and which to reduce, or eliminate, if severe water restrictions are implemented.

Water supply will be an important concern in 2008. The weather has been cooperative early in the year, with precipitation at or above normal across most of the state and the areas that feed the Colorado River.

Because recent years were relatively

dry, however, the water actually in storage is well below average. Furthermore, water allocations to parts of the Bay Area, Southern California and the San Joaquin Valley will be reduced this year, following a federal court decision to curtail Delta pumping by the state and federal water projects in order to protect the endangered Delta smelt.

Real Estate: The Housing Crash

The downturn in housing has worsened over the last three months

along with conditions in the primary and secondary mortgage credit markets. Here are some of the grim statistics for the resale home market.

- Existing single-family home sales in California plunged -33.4 percent over the year to December 2007, while condos sales were down -35.6 percent.

- Prices also have fallen, with the median price of single-family homes sold in December 2007 down by -16.5 percent compared to December by 2006.

- The number of homes available represented 14.5 months supply — at December's sales rate — compared to a more normal 5.9 months a year earlier.

The declines in home sales and prices are exacerbated by the scarcity of jumbo mortgages. Because they can be sold readily in the secondary market, most primary mortgage lenders are dealing only in so-called conforming mortgages, which top out at \$417,000. This is not sufficient to purchase a typical home in many California communities.

The new Economic Stimulus Act contains a provision that will boost this limit in many parts of California through December 31, 2008 by varying amounts depending on median home prices. However, the details have not been worked out, and it is unclear how many buyers in practice will be able to take advantage of

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the higher limit.

Residential construction also has plunged. A total of 112,300 new home construction permits were pulled during 2007, down -32 percent from 2006 (and by -47 percent from the 2004-05 peak). Single-family homes have been most affected, with only 68,000 permits in 2007, down -37 percent from 2006.

The 44,300 new multi-family permits issued in 2007 were down by “only” -21 percent. As in the resale market, many new home builders have standing inventories of “largely completed but not yet sold homes.”

Construction of new homes is dropping and effective prices are falling, as they must before the unsold inventories can be cleared and the bottom of the cycle reached.

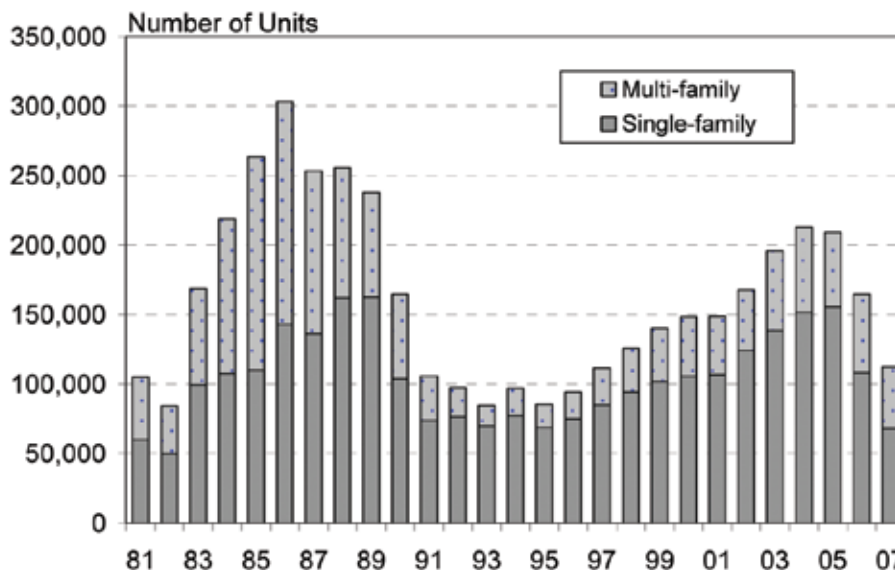
This process will take a while. Industry observers do not expect any significant improvement before the end of 2008, with some areas not reaching bottom until a year or more later.

In contrast to the residential situation, most of California’s commercial real estate markets held up fairly well in 2007. Office markets are mixed, reflecting the mixed trends expected for employment growth in office-based industries.

Vacancies are high, and rising in Orange County and San Diego, and rents look weaker there than in the rest of Southern California. The Bay Area appears to have the best employment prospects, although even here cautious hiring may cause vacancy rates to rise.

Industrial markets look solid almost everywhere, with extremely low vacancy rates in Los Angeles County. Again, vacancies may tick up if activity slows substantially.

California Housing Permits



Source: Construction Industry Research Board

There’s been a minor boom in new hotel projects in several areas, and more are under consideration. Most apartment markets look reasonably good, though demand is lagging in the Inland Empire where renting foreclosed homes provides an alternative.

However, financing for most types of new commercial real estate projects has become harder to come by. As loan commitments decline, the construction pipeline will empty out.

Risks

Risks are mostly to the downside in this environment. Troubles in the state’s housing markets could worsen further, especially if prices continue to decline. Markets won’t adjust until enough sales take place and inventories are reduced. Falling prices give buyers an incentive to wait (to see if they fall any further), and sellers an incentive to turn in the keys and simply walk away from their homes (if the mortgage is under water).

If/as defaults and foreclosures rise, the spreads of mortgage rates over U.S. Treasury bonds could widen further. Finally, the more home prices fall, the

more likely the “wealth effect” will kick in, causing households to restrict spending and save more to rebuild their nest eggs.

More volatility in global capital markets might reduce the willingness of financial institutions to take on mortgage-related debt and also engage in ordinary business and consumer lending, worsening the current credit crunch and slowing business

and household spending.

Rising energy prices continue to be an important risk factor. Higher prices of gasoline and other energy-intensive products actually shrink the amount of consumers’ income available for other types of purchases.



The California Chamber of Commerce Economic Advisory Council, made up of leading economists from the private and public sectors, presents a report each quarter to the CalChamber

Board of Directors. The council is chaired by Nancy D. Sidhu, vice president and senior economist for the Los Angeles Economic Development Corporation.

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