Highlights of the California Forecast

- After nearly a year of mild recession, the economy entered a steep nosedive this fall. Gross State Product will decline at nearly a 3% annualized rate through the first half of 2009.
- The state's recession should end by the 4th quarter of 2009, but the job market will remain weak through most of 2010.
- Unemployment will approach but not exceed 10%. Unemployment peaks at about 9.6% in late 2009 and remains over 9% for all of 2010.
- Payroll employment will decline by 400,000 jobs during the recession with the largest layoffs still to come. Statewide payroll declines will approach 50,000 per month in the next quarter.
- Manufacturing will lead the decline in 2009 and 2010. About 120,000 manufacturing jobs will disappear in the next 3 years, a decline of 8.5%.
- Healthcare, Private Education, and Other Services (e.g. repair and maintenance, civic organizations) are the only sectors that will not contract in 2009. Even these sectors will experience very slow or no growth.
- Real personal income grows only 0.3% in 2009, and a modest 2.0% in 2010.
- Construction employment will continue to contract, but at a slower pace than the overall economy. Over 130,000 jobs have been lost in this sector to date, and construction jobs will decline by another 60,000 before it ends.
- Housing starts hit bottom in late 2008 at about one-fifth of its peak levels statewide. Competition from foreclosure properties, a general recession, and tight financing keeps housing starts at this depressed level through all of 2009. 2010 housing starts will strain to reach nearly 100,000 units, and will slowly increase thereafter to keep pace with a growing population.
- Auto sales have decreased more than 35% from 2006 after exceeding 2 million new car and truck sales for most of the decade. These sales will rebound more quickly than homebuilding, and could once again reach 2 million units in 2011.
- Retail sales will decline $30 billion (6%) over the next year, and create severe problems for state and local governments that depend on sales tax revenue.

A Mild But Long Housing Recession Transforms into a Financial Crisis and Severe Recession

It is well known that the roots of the recession are in the housing market collapse. A housing downturn impacts the overall economy through three channels: income effects, wealth effects, and financial market effects. Income effects are the first to hit the economy and include lost employment and wages for those working in construction, real estate, and related financial sectors. The wealth effect hits next and is the impact of declining home equity on consumer spending. After these take hold, financial market effects may appear. Financial market effects are increasing losses on real estate loans for financial institutions that lead to greatly constrained credit across the economy. The first two (income and wealth effects) are better understood, and we have historical precedents that can be used to predict the magnitude of their economic impact. Together, they have hit California harder than most of the rest of the country and added up to the "shallow, but long" recession scenario that has characterized our California forecast for the past year.

The financial market effect has always been the most uncertain and potentially most devastating of the three. Until September, it looked as if the creative and aggressive policy actions of the Federal Reserve might be enough to ward off the most serious financial crisis scenario. After the dramatic collapse and "rescue" of Bear Stearns in March, the Fed moved beyond its normal role in cutting short-term interest rates (primarily through the purchase of Treasury bonds), and undertook aggressive actions to backstop the financial system such as opening up previously unavailable lending facilities to investment banks, and accepting lower quality assets (such as mortgage backed securities) as collateral. Six months passed between Bear Stearns in March and the bankruptcy of Lehman Brothers in September.

In September, it became clear that these policy actions (as well as banks own efforts to raise capital) had postponed, but not averted, a large-scale financial crisis. Unfortunately, the Treasury Department did not take advantage of the time to develop an effective, comprehensive plan of action for a banking crisis. Instead, we had a hastily conceived and poorly defined bailout program (aka the "TARP") that has morphed from purchasing "troubled assets" to following the British and European model of injecting capital directly into the banking system. Treasury Secretary Hank Paulson has eventually moved in the right direction (investing directly in banks is more effective than buying their unwanted mortgage backed securities), but the lurching back and forth has cost valuable time, increased uncertainty and reduced confidence.

Fortunately, we have a much steadier hand at the helm of the Federal Reserve. This summer many analysts called on Fed chairman Ben Bernanke to increase interest rates to "pop" the commodity bubble and head off inflation. We are fortunate that Bernanke ignored this advice, as oil prices have dropped below $50 in a few months (a decline more rapid than Stockton home prices) and deflation is the new economic worry. Recently, the Fed has worked to free up credit markets and support the economy by purchasing high-quality commercial paper and lowering mortgage rates through the direct purchase of mortgage backed debt of Fannie Mae and Freddie Mac. These moves are not without controversy and risk, but have been among the most effective policy moves to avoid even greater financial stress.

In the months ahead, we will know more about the actions of the Obama administration and the new Congress. A large fiscal stimulus package is warranted and will be forthcoming, but the details are still to be

Table 1. California Annual Forecast Summary

	2008	2009	2010	2011
Real Personal Income (% change)	1.6	0.3	2.0	2.8
Real Gross State Product (% change)	1.1	-1.7	2.3	3.6
Non-Farm Payroll Employment (% change)	-0.4	-1.8	0.5	1.8
Unemployment Rate (%)	7.1	9.3	9.4	8.5

determined. We can be reassured that President-Elect Obama has chosen a skilled economic team that will supply him with sound advice. At this point, we don't know if he will follow their counsel or follow more politically expedient but less-effective proposals that could emerge from Congress or his political advisors. Assuming an effective policy response (which includes a more effective mortgage relief plan that encourages principal write-downs) and some calming of financial markets, the U.S. economy should lift out of recession in late 2009. California could turn a bit earlier.

The California Outlook:

State Budget and Housing Are Bad, But Aren't the Biggest Worries

Despite the constant media attention on the state budget standoff and collapsing housing market and homebuilding industry, these two areas aren't the greatest concern in the economy. As bad as the news has been for state workers lately, their jobs are still more secure than their private sector counterparts. Construction continues to shrink, but at least that sector has already been through its worst days. Through October, the state's economy has shed about 100,000 jobs, about 25% of the 400,000 jobs expected to disappear before the recession bottoms out next fall. Over the winter, California payrolls could drop by 50,000 jobs per month. The state's unemployment rate is forecast to peak at 9.6% at the end of 2009, and should remain above 9% for all of 2010 as the recovery slowly gains its footing. We can't rule out double-digit statewide unemployment.

After bouncing around zero growth for the past year, gross state product is diving and looks to decline at about a 2% annualized rate for the next three quarters. California's economy will hit bottom in the 3rd quarter of 2009, a few months before the U.S. The state went into the recession earlier and harder than the U.S., and as a result we are nearly finished with declining real estate prices. The greater home affordability lowers California's notorious cost of living and improves its competitive position heading out of the recession. In addition, the state's technology base and leadership on global warming issues leave it well-positioned to benefit from the green-tint to the stimulus program likely to emerge from Washington this winter. On the downside, the global recession and strengthening dollar are beginning to hurt the burgeoning export industries that kept the first half of the recession relatively mild.

Of the ten main sectors in the California economy, construction and state and local government will actually rank in the top half in terms of job creation. Unfortunately, it's not much of an accomplishment as a sector shedding less than 2% of jobs in 2009 qualifies as a relatively strong sector in 2009. Only two of the ten sectors, Private Education and Healthcare, and Other Services (e.g. auto repair, as we fix our old cars rather than buy new ones) will narrowly avoid contraction next year.

As mentioned above, although construction jobs will continue to shrink, this is now the least of our worries. We expect another 60,000 jobs lost in this sector statewide, on top of the 130,000 that have already vanished since the construction peak in 2006. However, the rate of construction decline (-1.6% in 2009) is less than the overall state economy (-1.8% in 2009). By late 2009, construction will receive a boost from public infrastructure investment that will stop further losses until homebuilding regains strength in 2011.

The decade-long slide in Manufacturing will deepen significantly, making this the worst performing sector in 2009 and 2010. Manufacturing will continue to see steep losses in 2010 even as other sectors begin to rebound. Over the next two years, Manufacturing is predicted to lose over 120,000 jobs, an 8.5% decline. Durable goods such as transportation equipment, computers and electronics, and fabricated metals will see cyclical declines along with non-durable manufacturing sectors such as printing.

Table 2. California Quarterly Forecast Summary

	2008Q4	2009Q1	2009Q2	2009Q3	2009Q4
Real Personal Income (% change, annual rate)	-1.3	1.2	0.6	1.2	1.5
Real Gross State Product (% change, annual rate)	-3.3	-2.7	-2.2	-0.7	1.2
Non-Farm Payroll Employment (% change, annual rate)	-2.1	-2.6	-2.8	-0.8	-0.1
Unemployment Rate (%)	8.3	8.9	9.3	9.5	9.6

Other poor performers include Finance, Trade and Transportation, and Professional and Business Services, all of which will lose at least 2% of their jobs in 2009. Professional and Business Services losses will be concentrated in the administrative support area (down 50,000 jobs in 2009, many of which are staffed by temporary employment agencies), rather than higher paying engineering and scientific fields. Retail trade and finance will extend their 2008 losses by another 20,000 jobs each in 2009.

Table 3. Central Valley Metro Forecast Summary

Metro Area	Payroll Employment (% change)		Real Personal Income (% change)		Unemployment Rate (% change)	
	2009	2010	2009	2010	2009	2010
Stockton	-1.3	1.0	1.0	2.7	13.0	13.1
Modesto	-1.7	0.8	0.5	2.4	14.4	14.5
Merced	-1.7	0.6	0.5	2.1	15.6	15.8
Fresno	-1.8	0.9	0.4	2.3	13.3	13.4
Sacramento	-2.0	1.0	0.4	2.4	9.1	9.2
California	*-1.8*	*0.5*	*0.3*	*2.0*	*9.3*	*9.4*

NOTE: Sacramento MSA includes Sacramento, El Dorado, Placer and Yolo counties. Stockton, Merced, Fresno and Modesto MSAs correspond to San Joaquin, Merced, Fresno and Stanislaus counties.

Central Valley Outlook:

The General Recession Hits Harder than the Housing Collapse

Central Valley metro areas (especially Stockton, Modesto and Merced; with Sacramento and Fresno close behind) have led the nation in foreclosures and subsequent housing price declines. A housing market collapse has induced recession in these regions, but the recession has been relatively mild up to now. In fact, some of the region's metro areas (Fresno and Stockton) were among the last areas of the state to post total employment declines. The reason is that while the real estate sector was in the midst of its spectacular collapse, other larger sectors of the economy excelled. In particular, the Valley's mainstay agriculture industry and related food manufacturing sectors have been thriving in an environment of strong prices and export demand fueled by a weak dollar. Other service sectors expanded to satisfy past population growth even as homebuilding and new population growth slowed.

Now a global recession has taken hold, the dollar has strengthened, commodity prices fall, and a drought threatens water supplies for next year's crops. While home prices are beginning to find a bottom and real estate sales have surged with low prices, the outlook for the Agriculture industry, Trade, Transportation and other key service sectors have weakened substantially in the past three months. Foreclosure rates have stopped rising but remain elevated and will stay elevated in the absence of a more effective policy response that can mitigate the problem of negative equity. The state budget crisis is having a major impact in Sacramento, no matter whether its largest impact is through income reductions (e.g. furlough days) or direct layoffs. Construction will remain stagnant for another year.

The result will be a stunning return of unemployment rates to the teens across all Central Valley except Sacramento. Nevertheless, unemployment from Stockton to Fresno will still be a few percentage points lower than the 15-16% rates of the early 1990s. In many ways, it is more surprising to see Sacramento's unemployment rising over 9%. Like the rest of the country, Sacramento hasn't seen such a high unemployment rate since the deep recession of the early 1980s.

After a tough 2009, the Valley is poised for a strong recovery as we begin the next decade. Population and income growth in the past decade have brought new services that have mostly increased the region's quality of life and business climate. Housing affordability has returned, and will make the region more attractive to commuters and investors alike.

Bay Area Outlook:

Silicon Valley Deteriorates Sharply

The dreadful economy of the East Bay has been the story of 2008. Contra Costa and Alameda Counties have accounted for virtually all of the 20,000 jobs lost in the entire Bay in the first three quarters of the year. Some parts of eastern Contra Costa County and most of Solano County have seen foreclosures and home price declines that resemble the Central Valley. Their problems, however, have gone beyond construction. Significant losses have also occurred in retail trade (e.g. Mervyns) and finance (e.g. Washington Mutual Center in Pleasanton), and the impacts have spread into commuting areas in Solano and San Joaquin County.

The worst news will move from the East Bay to Silicon Valley as we move into 2009 and 2010. In 2008, San Jose (and to an even greater extent San Francisco) weathered the housing downturn with little damage to their economies. In part, this was because there was no home building boom in these areas and therefore no subsequent collapse in construction employment. Unfortunately, our forecast is that the deepening U.S. and global recession will have significant impacts on the computer manufacturing and associated software and computer engineering sectors that make up San Jose's economic base. Many technology investments will be deferred over the coming year, and will result in as much as 10,000 lost manufacturing jobs with smaller losses in affiliated information technology and engineering fields. The damage will be nowhere near the magnitude seen when the technology bubble collapsed earlier in the decade, but San Jose is still the only metro area in northern California forecast to continue losing jobs into 2010.

San Francisco will continue to be the strongest economy in the Bay area, although the recession will finally be felt in its finance and hospitality industries. Vallejo is a commuter oriented metro area that was struggling even before the current recession started, but could see some revitalization towards the end of next year thanks to declining gas and housing prices, and the ongoing redevelopment of Mare Island. Napa will see the biggest downturn in 2009 as a tourism slump hits the local hospitality sector and wineries.

Table 4. Bay Area Metro Forecast Summary

Metro Area	Payroll Employment (% change)		Real Personal Income (% change)		Unemployment Rate (% change)	
	2009	**2010**	**2009**	**2010**	**2009**	**2010**
San Francisco	-1.4	0.4	0.9	1.8	6.5	6.6
Santa Rosa	-1.9	0.2	0.9	2.2	7.5	7.6
Oakland	-2.0	0.4	-0.2	1.7	8.2	8.3
Vallejo	-2.1	0.9	0.9	2.5	9.0	9.1
San Jose	-2.2	-0.1	0.2	1.8	8.3	8.4
Napa	-2.3	0.7	0.1	1.9	6.8	7.0
California	*-1.8*	*0.5*	*0.3*	*2.0*	*9.3*	*9.4*

NOTE: San Francisco MSA includes San Francisco, Marin and San Mateo counties. Oakland MSA includes Contra Costa and Alameda counties. San Jose MSA includes Santa Clara and San Benito counties. Napa, Santa Rosa, and Vallejo MSAs correspond to Napa, Sonoma and Solano counties.

BUSINESS FORECASTING CENTER WEBSITE

http://forecast.pacific.edu

In addition to the quarterly forecast, the following reports and data are available free on our website.

REGIONAL ANALYST
This quarterly series examines San Joaquin County economic and demographic data in depth. Our analysis of the county's housing market and future housing needs will be released in December. Previous issues have examined the Economic Impact of Agriculture, Population Projections, Migration Patterns and the Economic Impact of Commuters.

COUNTY DATA PROFILES
For each of California's 58 counties, we compile and annually update a 50 page report with historical data on personal income, earnings, employment, regional income & expenses, transfer payments, labor force statistics, demographic profiles, and commuting patterns.

SPECIAL REPORTS
The Center periodically produces special reports on topics of current interest. Most of these are available on our website. The most recent report examines the economics of ending Delta water exports versus a peripheral canal. Earlier reports include the economic impact of non-profit organizations.

VALLEY ECONOMY BLOG
Dr. Jeff Michael, Director of the Business Forecasting Center, comments on current economic, business and environmental issues of importance to the Central Valley at *http://valleyecon.blogspot.com/*