

# Beacon Economics White Paper #1

## The California Economy: Singing the Housing Blues

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*Overview: Bubbles, Busts, Bonds, and Budgets*

The midterm elections have come and gone, and Schwarzenegger has won another term as head of state.<sup>1</sup> There is much good news for California. Many parts of the economy are performing better than ever, including manufacturing, logistics, tourism, professional services, and the information sector. Government revenues continue to grow, and the slew of infrastructure bonds that were just passed will give California the ability to start investing in its highly stressed transportation systems. Incomes are rising solidly and unemployment remains low. Energy prices have fallen, inflation has moderated, and interest rates remain low. And California is finally facing a national legislative body with a majority that matches California's political leaning, with the new Speaker of the House coming from San Francisco. For now, California is no longer left in the political hinterlands of the nation.

But as we look toward 2007, the entire economy is being threatened by the very sector that drove so much of the growth until just a few years ago—housing. The bubble that has driven prices up to record highs at both the state and national levels has popped. Sales activity is plummeting, new building permits are falling, prices have flattened, and notices of foreclosures are starting to rise. The housing bulls have shamelessly continued to champion the housing market in spite of the pop. After denying there was a bubble at all, they then claimed that a soft landing was all but assured. And even when finally being forced to acknowledge that nominal price decreases in housing are almost a certainty, they still claim in public forums that the worst is behind us. It isn't; rather, it is in front of us. The housing market will hit bottom sometime early in 2007, and the full consequences of the years of excess will be known only then.

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<sup>1</sup> This white paper was completed in November 2006 and includes data and information available up to that date.

In the wake of this slowdown will be a variety of direct and indirect problems. Employment growth will take a hit, particularly in housing-related sectors such as mortgage banking, home building and renovation, retail, and real estate. Perhaps as critical as the changes in employment will be the influence of stagnant or decreasing housing prices on consumer spending, and the effects of a cooling market on overall spending. Taken together these indicate a slowdown in economic growth at best and the potential for an economic recession at worst, depending on whether the non-housing economy continues to grow. This outcome is a toss-up at this writing.

### *Implications for California*

What does it all mean for the state? For one thing, the state's budget problems, never really solved after the 2001 collapse, will come back to haunt us. While we do not face the same declines in revenues as in 2001, the state currently has fewer options to cover the budget gap, with fewer reserves, fewer places to find easy fat to cut from the budget, and a load of new debt. We may try to borrow our way out of our troubles again, but the bond markets will be shy about lending even more money to a state that cannot seem to face up to the fundamental decision to either cut deeply into some large social programs or raise taxes.

As for housing prices, we can expect to see slow nominal declines over the next two or three years, even as the market bottoms out, but it is unlikely that—short of some secondary shock to the economy—we will see the same kind of price declines the state faced in the early nineties. It isn't clear that this is necessarily a good thing. California now is home to five of the six most expensive places to live in the nation. High-cost housing makes it difficult for businesses who want to recruit from out of state and drives middle-class families far away from employment centers in search of affordable housing. The declines in the pace of building will cause our already bad housing shortage at the low end of the housing market to become that much worse.

California remains one of the best places to live in the country, so the state will work through these difficulties and eventually thrive again. But the problems we face will take their toll over the next two or three years. The good news is that in crisis comes opportunity. Perhaps this shock

to the economy will help us create the political will necessary to fix some of the long-term problems we face.

### *Singing the Housing Blues*

For several years, I have been warning Californians about the growing real estate bubble and the potential negative effect it could have on the local and national economy when it broke. Now the waiting is over. The bubble has indeed popped, and we are waiting to see the full consequences of the excesses witnessed over the last few years. The uniqueness of this housing bubble, in terms of its size and longevity, along with the distended state of consumer finances and the mortgage frenzy, has put the U.S. and California economies in a unique place from a historical perspective, which makes it an interesting time for the victorious democrats to be taking over the reins of government. What is clear is that a popping real estate bubble will have slowly emerging consequences. Real estate is still in the midst of its decline, and the bottom of the market will not be seen until early 2007. The majority of economic risk still remains in next year's economy, despite the current slowdown in GDP growth.

What is an asset bubble? It's a market where the selling price of the asset has been pushed far above any reasonable estimate of what the fundamental value can be. If an asset is some product, financial or physical, that provides a stream of value in the future, then the current price of the asset should be the net present value of these expected future flows. Because different people may have differing expectations of what these values might be, we have an active market in trading these products. For stocks, future flows are based on firm profits. For a bond, it's the coupon payments. For a house, it is the implied rental value that the home provides to its owners, whether they rent it out or live in it themselves, in the future.

The reason that asset markets sometimes become bubbles is that people tend to think in terms of trends instead of in terms of fundamentals. Between 1997 and 2003, the trends in housing values were positive because of changes in the underlying fundamentals in California and in the rest of the nation. During the first half of this time period, we had solid economic growth. Higher incomes pushed the implicit rental value of homes up because of the increase in demand. Then,

when the economy cooled during the mild downturn of 2001, mortgage rates began to fall dramatically, from above 9 percent to below 5 percent at one point in time. The mortgage rate is the primary driver of real estate discount rates. When the discount rate falls, those future value streams become worth more today, and hence the price of a home rises. A good rule of thumb is that a one percentage point shift in the mortgage rate leads to a 10 percent swing in the fundamental price of an asset. Note that the implication here is that home buyers are not necessarily better off in a low interest rate environment—instead the lower rates are offset by higher prices. Current home owners, however, do see a real increase in their net worth as a result of falling rates.

At the start of 2003, all indicators pointed toward a slowing in home price appreciation. Income levels and the general economy were still recovering from the downturn, and interest rates started to come up at a slow pace. But at this time speculation started to play a role. For anyone not paying attention to the fundamental indicators, buying a house looked like a heck of a deal. Betting on a continuation of housing trends, people moved in to get some of this ‘free money,’ causing prices to go up—a self-fulfilling prophecy. Watching others make easy money caused more people to want to get into the market, causing prices to go up even more. The feeding frenzy built on itself. And it was fueled to even higher levels, first by a real estate industry that fell over itself telling everyone that everything was fine, and subsequently by a mortgage market that allowed people to invest in properties they couldn’t otherwise hope to afford on the basis of all sorts of shady dealing: no documentation loans, special introductory offers, negative amortization loans—offers that seemed like good deals. But the good deals lasted only as long as prices continued to go up.

How big was this run-up in prices? Historically speaking, what we have seen is absolutely unprecedented. From the start of the run-up in prices in the late nineties until today, California has seen prices rise by almost 200 percent. The median price of an existing single-family house in the Bay Area was \$260,000 in 1997—today that same median house costs \$690,000. In Southern California the figures are \$170,000 and \$500,000, respectively. To put this in perspective, in the last bubble, overall prices in the state rose only about 100 percent in a period of time when inflation rates were higher.

And it isn't just in California. The increase in prices is unusual both in terms of magnitude, with a record increase in national prices (though price increases have been largest in California, with Florida and New York lagging in second place), and in terms of reach, with prices increasing everywhere, as opposed to rising in only one or two places. Some of these price increases are justified by the fall in interest rates and the generally robust economy, which has been growing, on average, at a faster than normal pace for a decade now. But in no way can these factors explain all of the increases or even a significant portion of them.

The run-up in prices has been closely matched by a rapid run-up in construction activity. Home builders have been eager to cash in on home buyers wanting to upgrade from their current residence as well as speculators wanting to purchase homes for their investment value. Over the past three years, the U.S. economy built 1.40 new homes for each new household, a considerably higher rate than the long-term average of about 1.05 new units per new household. Spending on new residential construction, as well as spending on fixing up existing homes, hit a whopping \$5,400 per household in real terms, twice the long-term average rate of spending.

A tremendous amount of spin was handed out by various organizations that had a vested interest in the housing bubble. Numerous theories were floated to justify what was happening, from boomers buying second homes for retirement to increased demand being driven by inheritances. The truth is that this was a housing bubble whose only unusual feature was its size. It couldn't last; at some point in time, like any pyramid scheme, reality had to interpose itself on the market.

**Nominal Price Appreciation in Select California Cities\***  
1980's compared to current markets, trough to peak

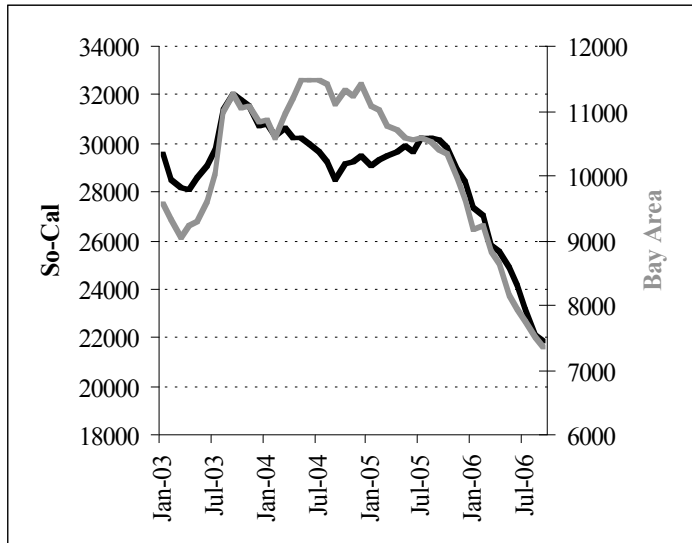
	<i>Current</i>	<i>80's</i>
Bakersfield	182%	36%
Chico	176%	60%
Fresno	186%	49%
Los Angeles	232%	118%
Merced	228%	69%
Modesto	215%	103%
Napa	227%	124%
Oakland	222%	102%
Oxnard	220%	121%
Redding	165%	71%
Riverside	229%	79%
Sacramento	193%	93%
Salinas	257%	115%
San Diego	225%	96%
San Francisco	198%	144%
San Jose	204%	127%
San Luis Obispo	216%	122%
Santa Ana	238%	92%
Santa Barbara	247%	103%
Santa Cruz	213%	118%
Santa Rosa	204%	113%
Stockton	217%	85%
Vallejo	220%	93%
Visalia	142%	61%

\* Source: OFHEO

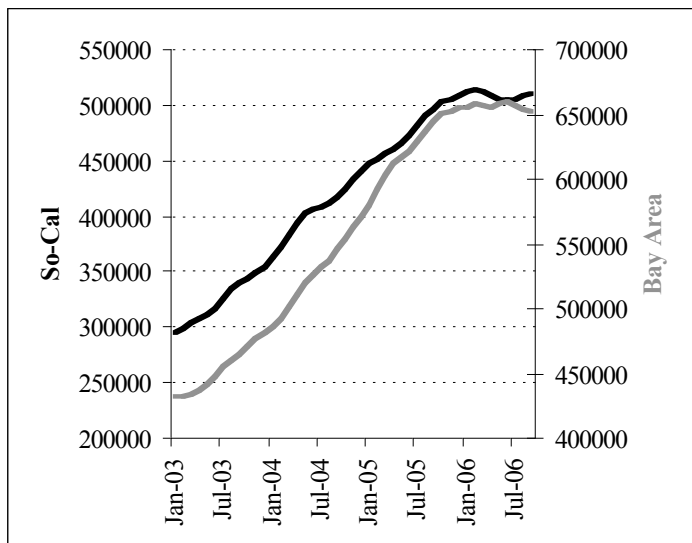
The leading indicator of the end of the housing bubble is market activity. When sales start to fall, it implies that the frenzy is over. The lack of activity causes a rapid buildup in inventories of new and existing units. This in turn puts pressure on prices, which typically stop rising within six to nine months. The construction industry responds to the slowing with a major pullback in construction.

The proof of the pudding is in the eating, as the saying goes. No matter what position you held during the bubble debate, it can no longer be denied that the bubble has burst. Unit sales, which had been at a plateau for over two years, started to fall rapidly in the last quarter of 2005, and as of September 2006, unit sales activity was down by a full third. There is no slowing in this trend at this writing, and inventories of homes for sale continue to grow. For a while, the industry was talking about a soft landing, inasmuch as prices were still rising even as market activity was falling. But prices stopped growing within six months of the sales declines and have even seen some slight declines.

**California Real Estate Sales Activity, (Units) SA**



**California Median Prices, Single-Family Homes SA**



Data Source: Dataquick

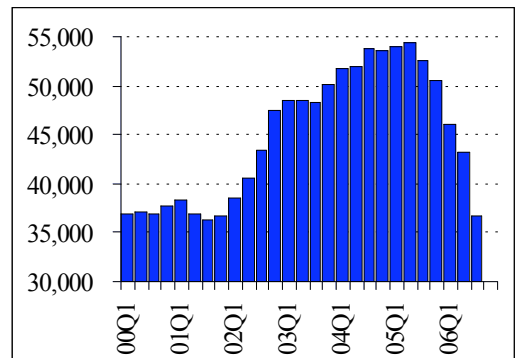
It should be noted that these data are noisy, and the percentage changes are not big enough to indicate a collapse in prices—indeed a collapse in prices is highly unlikely given the growth in labor markets and the strength within the non-housing portion of the market place (see the next two sections of this white paper). But the worst is not over. Quite the contrary, this market has a way to go before the full extent of the problem is seen.

*Effects of the Slowdown*

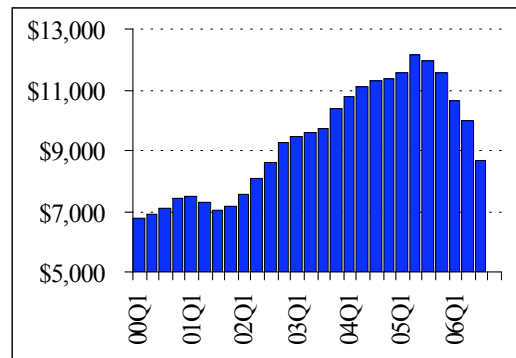
First we will consider the direct ramifications of the slowdown in the housing sector. Over the last few years the state has experienced a solid drop in the unemployment rate, a decline directly related to the construction markets. At the peak of the 2000 bubble, the state directly employed 780,000 people in construction, with another 200,000 or so in construction in the informal sector (outside of normal payroll employment). Today the numbers are 940,000 and 350,000, respectively. This surge in jobs has been due entirely to home building, both in primary construction as well as in home renovation.

In 2000, the state permitted the construction of less than 150,000 units. In 2004 and 2005, about 210,000 new units were permitted, a substantial increase even in the midst of what was a cool economy until late 2004. With the cooling of the housing market, the number of permits has fallen very sharply. As of the third quarter of 2006, permits had fallen to an annualized pace of 140,000, with no sign of slowing. Falling permits today means a loss of jobs in six to nine months; between 200,000 to 300,000 jobs are directly at risk over 2007-2008.

**Residential Permits: Units (SA)**



**Residential Permits: Value (\$Bil, SA)**



Source: Construction Industry Research Board

Construction isn't the only sector to take a direct hit. The mortgage industry, after strong growth, is also feeling a chill, with sales falling rapidly and home equity loans looking less and less like a good deal for those who want to cash out on the home ATM. To this economic picture, we have to add in the risk that Orange County faces as the de facto home to the national sub-prime lending business. The slowdown has also affected those people filling out the ranks of the real estate industry. (The state now has a record number of people with real estate licenses in a market that is going to see reduced transactions for some time to come.) Home builders will be similarly strained.

### *A Housing Shortage?*

The slowdown in housing may come as a surprise. We have been hearing about the massive “housing shortage” in California. There is indeed a housing shortage in the state—California has built new residences relative to population growth at a pace that is 75 percent of the national pace. In general, the state's complex and time-consuming zoning system for construction—combined with a costly regulatory system, local zoning board intransigence, and stiff environmental rules—has served to restrict the pace of building. However, the burden of this shortfall has not fallen upon California's homeowners. Single-family homes are high-margin projects and tend to be far more politically acceptable to local communities. Rather, the burden of this shortfall has fallen upon those who are normally at the lower end of the housing scale—renters and those who need low-price, entry-level housing.

The shortage in low-cost housing has led to high overcrowding rates, particularly in the southern portion of the state. California has had, and continues to have, the second-worst crowded housing problem in the nation—where crowded housing is considered to be one or more people per room in the residence—currently 8 percent of all housing units in the state. Unfortunately, the state has not spent the past few years building low-cost housing. Instead, we have been building high-end houses and high-end condos. In spite of our lack of investment in low-cost housing, the overcrowding rate has fallen a bit over the past few years—primarily through a system that might best be termed ‘trickle-down housing’: building high-end units frees up low-end units. The overcrowding rate in the state was 10.5 percent in 2002.

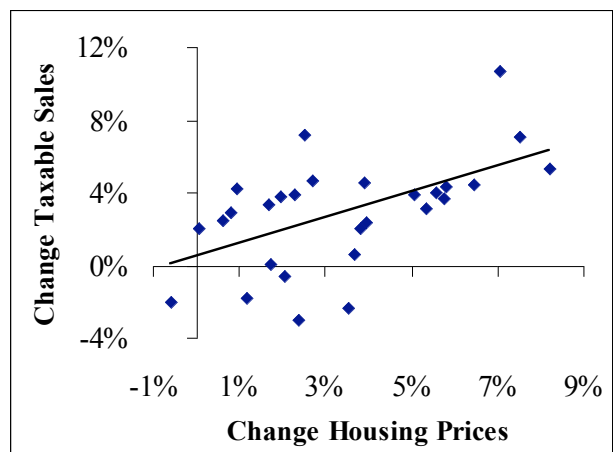
This trickle-down effect has only provided a limited solution, dependent on demand for new homes to free up units at the lower end. Indeed, the mismatch between high-end supply and low-end demand is such that the number of vacant housing units in the state has been rising despite the need. With the cooling of the market, the demand at the top end is rapidly withering up, and permits have fallen despite the still substantial need for low-cost housing. With little sign of any substantial change in the building regulations that will help encourage more direct construction at the low end, it seems likely that the overcrowding rate will increase.

Crowded housing is not a minor issue. Expensive workforce housing puts pressure on our infrastructure systems, as middle-class families are forced to live far away from jobs in order to afford a place to live. A lack of affordable housing makes it difficult for firms to recruit high-quality workers from out of state. Low-income families, primarily new immigrants, typically pay 40 percent to 50 percent of their household income to cover their rent. Under these circumstances, both parents need to work 40 hours or more per week, leaving them with neither the financial resources nor the time to support their children's efforts to obtain an education. This lack of resources puts a strain on our public education system and our social safety net.

### *Consumer Spending*

The slowdown in the housing sector has secondary effects as well, such as the potential impact on consumer spending. Spending in the United States has reached a new height, with personal savings rates dipping into negative territory; this is the first time since the Great Depression that

**Home Prices and Taxable Sales**  
05Q4 to 06Q2 by California MSA



Sources: California Board of Equalization (Taxable Sales) and OFHEO (Housing prices)

we have seen this situation. There are few explanations for all of this spending beyond the new housing wealth being created in the United States and in California.

In 2005, the state saw almost half a trillion dollars in new housing wealth created, an amount equivalent to 50 percent of the total income in the state. Given the condition of current markets, housing wealth will likely decline in 2007. That shift will be a huge swing in trend wealth creation, and might very well affect consumer spending.

The pace of home market slowing has not been even across regions. Some places are still seeing prices rise, albeit at a slower pace. Other markets, such as Sacramento, started popping earlier and are already experiencing some declines in home prices. Taxable sales growth slowed sharply in those markets that have seen the price growth of homes slow sharply relative to those that are slightly behind the curve. Yet it is clear that the cooling will continue to spread and have a deeper impact on consumer spending across the state and indeed across the nation.

The cooling housing market will also have a secondary effect on the nation overall. The building industry is in steep decline—it's not just here in California. Consumers hold record levels of debt, and the pace of overbuilding in many parts of the United States is tremendous. The nation overall has averaged 1.5 new housing starts per new household over 2004-2006. But the long-term average is 1.05. This gap will result in close to 1.5 years' worth of excess supply of homes. Such an excess will not be erased quickly. A slowing U.S. economy will have an impact on the state economy, causing yet more turbulence. Additionally, there will be secondary effects stemming from the potential meltdown of the mortgage markets, a large unknown on the horizon.

### *State Fiscal Implications*

Clearly the changes in the housing sector will slow the economy tremendously next year. And for a state that has been relying on borrowed money to cover its state fiscal deficits for a number of years—hoping for revenues to catch up with spending—the slowdown cannot be good news. Given the governor's budget plan for fiscal year 2006-07, the state would have been left with

less than \$1 billion in reserves after using \$8 billion in leftover bond money to cover the current budget gap. Now the state faces a cooling housing market, cooling taxable sales, and a cooling employment market. None of this was built into the budget projections. Public revenues lag the economy, and the pain has not filtered down to Sacramento yet. But it will, and the budget problems created in the latter part of the nineties, problems which have never really been fixed, will come back to haunt the state. One has to wonder if Governor Schwarzenegger will regret his second term when these budgetary woes shake out!

The scenario outlined above sounds fairly grim, but there is one point of good news. From 2001 to 2004, the state's economy was largely driven forward by the housing economy. Over the period 2005-2006, however, there has been a shift toward the non-housing part of the economy. As will be shown in the next section, there are signs of strength that may help to offset the cooling housing market—somewhat.

California has seen some solid trends in the business economy. Despite complaints about the bad business climate and concerns regarding so-called “job-killer” problems, such as workers’ compensation costs, the state’s economy continued to grow faster than that of the nation in 2005.

In real terms, state output grew at 4.3 percent, according to the Gross State Product numbers released by the Bureau of Economic Analysis, as compared to 3.6 percent for the nation overall in the same year. Growth in 2004 was 5.2 percent in the state, compared to 4.2 percent for the nation overall.

*Manufacturing*

Leading the way for economic growth in the state has been manufacturing, which contributed almost a fourth to overall output. This outcome may be a surprise to anyone following the lackluster employment situation for that sector, which has failed to add few jobs during the economic rebound that started in 2003. This strikingly different measure is one of the proven results of the information technology revolution and outsourcing.

**California Gross State Product Numbers by Sector\***

	Real GDP		Growth Rates	
	2005	Share	2004	2005
Total	1,469,459		5.2%	4.3%
Agriculture	19,992	1.4%	-2.0%	0.4%
Construction	57,303	3.9%	6.2%	4.2%
Manufacturing	181,763	12.4%	5.2%	8.2%
Transportation	35,083	2.4%	2.5%	2.2%
Utilities	21,417	1.5%	2.1%	1.5%
Retail trade	112,874	7.7%	7.7%	3.3%
Wholesale trade	87,356	5.9%	2.3%	3.0%
Information	105,950	7.2%	17.2%	7.3%
Finance and insurance	108,376	7.4%	4.1%	8.8%
Real estate and leasing	226,126	15.4%	7.4%	3.0%
Professional technical	122,241	8.3%	6.3%	8.5%
Management companies	20,693	1.4%	0.8%	-11.1%
Administrative	44,358	3.0%	4.5%	5.0%
Educational services	9,188	0.6%	1.1%	0.9%
Health care	81,652	5.6%	3.7%	5.5%
Arts, entertainment	16,875	1.1%	1.5%	1.1%
Accommodation food	37,758	2.6%	5.4%	4.5%
Other services	31,509	2.1%	1.4%	2.4%
Government	145,709	9.9%	0.3%	0.5%

Source: Bureau of Economic Analysis

\* The numbers shown here are value-added measures—they measure total output minus the cost of all material inputs. In short, they represent the net output of industry, capital, and labor. This is why construction, which is a large employment sector, is a small share of gross state product. The value added is relatively small. Conversely, a small income and employment sector such as real estate and leasing is very large, as most of the value added in this industry has little to do with purchased inputs. Part of this sector is the rental value of all residential housing in the state for the year.

Manufacturing firms in California have expanded their ability to produce output by finding cheaper inputs from other nations, investing in new manufacturing methods that exploit the amazing low price of computing power, and using this capital deepening to handle increasing output. State exports have also been growing at a solid pace. The sector has now returned to where it was in 2000 at the peak of the tech boom. This time, however, the success is based on sound fundamentals. Firms are earning record profits.

### *Other Important Sectors*

In 2005, growth rates in professional services, as well as in finance and insurance, also contributed to an improved economic outlook. Growth in these sectors is a solid sign; these are high-income industries that support much of the rest of the economy. This expansion is a shift from 2004, when growth was centered on information and the real estate, rental, and leasing industry.

There are other solid signs of a growing economy in the state. Hotels have seen occupancy rates rise sharply, and nightly rates are rising as the traffic flows increase. The airports remain busy and the highways are packed—always a good sign that business is getting done. This healthy flow of activity may seem surprising given the state’s lack of investment in its fundamental infrastructure, especially during the budget crisis. Yet congestion and high housing prices are more of a drag on growth than a reverser of it. We must remember that congestion and high housing costs are in large part due to our own economic success within the state. If that success tapers off, the slowdown will take pressure off infrastructure and reduce congestion. Of course, this is not to say that congestion shouldn’t be addressed—even as a drag on growth this sector can be a problem. Clearly, the infrastructure initiative that the governor pushed will be a welcome relief for state residents and businesses. But the potential short-term negative effects of congestion are less severe than often touted.

The non-residential real estate market has also improved in 2006. Vacancy rates in office markets fell in every major market in the state—with the exception of the Inland Empire, which experienced such a massive increase in the stock of existing space (12 percent in one year, albeit

on a small base) that it couldn't all be absorbed. The decline in vacancy rates is associated with the growth in professional jobs in the economy. Rental rates also increased sharply in many markets—again indicative of more demand for space. This outcome is surprising since from an historical perspective vacancy rates are still quite high—there is lots of empty space in the market. We might speculate that these seemingly contradictory results are due to tighter conditions in central regions,

while peripheral facilities— which seemed logical to build during the frenzied building markets of 1998 and 1999— continue to languish. With record profits being enjoyed by corporate America, it seems probable that businesses are willing to bid high amounts for plum locations.

Industrial space—including both warehouses and manufacturing facilities—also saw falling vacancy rates and solid rental growth— indicative of the continued expansion of port traffic and logistics through the southern California region as well as the healthy state of the manufacturing sector.

### Non-Residential Markets

	Vacancy Rates		Rental	Stock	Gr.
	05 Q3	06 Q3	Gr.	000's sf	Stock
<b>Offices</b>					
East Bay	17.4%	17.2%	6.3%	88,718	0.7%
Inland Empire	12.0%	12.9%	4.0%	25,254	12.5%
Los Angeles	15.7%	14.8%	6.2%	334,893	0.4%
Orange County	12.0%	11.1%	9.7%	114,755	1.5%
Sacramento	13.4%	12.7%	3.8%	74,910	2.3%
San Diego	11.5%	10.7%	4.5%	103,710	1.8%
San Francisco	18.0%	16.1%	20.4%	107,313	0.6%
San Jose	22.0%	20.0%	11.4%	73,030	0.2%
<b>Retail</b>					
East Bay	3.9%	1.7%	3.3%	107,259	0.9%
Inland Empire	9.5%	10.7%	4.0%	143,224	4.0%
Los Angeles	9.3%	8.1%	5.2%	324,531	1.4%
Orange County	5.4%	3.8%	4.6%	128,148	0.9%
Sacramento	8.3%	8.8%	3.5%	65,967	3.9%
San Diego	3.3%	1.6%	6.6%	107,624	1.2%
San Francisco	7.0%	4.8%	4.9%	71,557	0.9%
San Jose	12.2%	11.3%	2.4%	63,195	2.0%
<b>Warehouse</b>					
East Bay	8.8%	7.2%	7.7%	114,787	0.2%
Inland Empire	5.6%	5.2%	7.7%	303,990	5.4%
Los Angeles	4.8%	3.9%	9.0%	446,250	0.6%
Orange County	7.6%	5.9%	6.6%	107,156	0.6%
Sacramento	9.2%	8.5%	5.0%	74,011	2.4%
San Diego	8.2%	7.2%	3.6%	73,947	1.4%
San Francisco	7.0%	7.0%	3.8%	35,116	0.0%
San Jose	9.9%	8.7%	5.6%	42,669	-0.6%

Data Courtesy of Portfolio & Property Research (PPR)

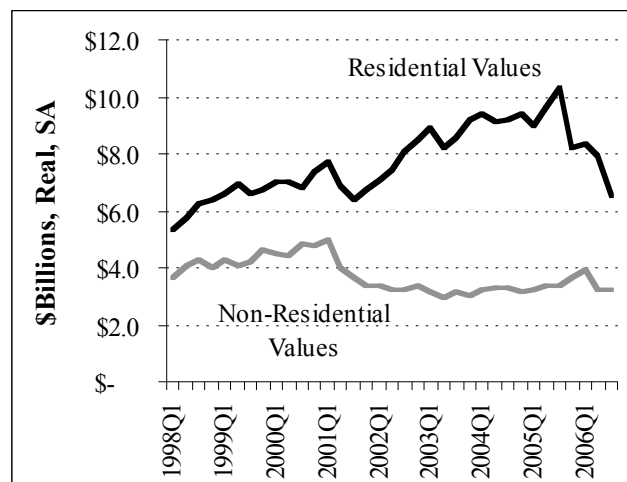
Retail space has been the star of the non-residential market in California, with vacancy rates below 2 percent in some areas. Rental growth for retail space was less strong than for office

markets, but this reflects the fact that rental rates for retail space did not drop as much in the wake of the 2001 downturn in the markets. This strength is hardly surprising given the strong taxable sales numbers in the state. Santa Clara expanded by a full 10.3 percent, while San Francisco and the Inland Empire saw growth of 8 percent over 2005-2006, second quarter to second quarter.

The one exception to these changes is in Sacramento and San Joaquin counties, where taxable sales have actually declined by 0.4 percent and 0.8 percent, respectively, in 2005-2006, second quarter over second quarter, on the basis of declining sales starting in the first quarter of 2006 (seasonally adjusted). Retail vacancies went up by a bit. This is not insignificant as the real estate markets cooled in Sacramento and San Joaquin before anywhere else. Indeed, prices in the region began to fall as of the first quarter of 2006, as opposed to the third quarter for the bulk of the state. In short, the spillover impact of the cooling real estate market on spending had yet to kick in for the rest of the state, but will be felt soon.

As for new non-residential construction, while the nominal values of non-residential building permits have gone up over 2005-2006, this increase was mainly due to the growing costs of construction rather than a true increase in the amount of building. In real terms, the number of permits in the state remains below where it was in 2000 and has actually tailed off slightly in the last two quarters of 2006. This result is surprising given the amazing low cap rates on sales of commercial properties in the state, driven down by low interest rates and lots of capital trying to find a worthwhile return.

**California Building Permits**  
Real, Seasonally Adjusted



Source: CIRB

## Taxable Sales Growth

2005Q2 to 2006Q2

Source: California Board of Equalization

<i>County</i>	<i>2006Q2</i>	<i>Growth</i>
Los Angeles	34,468	6.1%
Orange	14,309	4.5%
San Diego	12,134	4.3%
Santa Clara	8,208	10.3%
San Bernardino	7,924	7.8%
Riverside	7,546	8.2%
Alameda	6,369	6.0%
Sacramento	5,279	-0.4%
San Francisco	3,478	8.4%
Contra Costa	3,465	3.3%
San Mateo	3,261	5.3%
Fresno	3,136	7.0%
Ventura	3,082	4.0%
Kern	3,012	15.5%
San Joaquin	2,366	-0.8%
Sonoma	1,993	5.1%
Placer	1,908	6.6%
Stanislaus	1,834	1.5%
Rest of CA	16,956	5.6%

Some have suggested that the expected boom in non-residential construction would pick up the slack in the economy caused by the cooling housing market. The answer to this is, not a chance. At the height of the housing boom, residential permits came in at \$38 billion annually. Even at the height of the economic boom in the late nineties, non-residential construction only tallied up to less than \$20 billion—half the size of the residential market. Additionally, most non-residential spending uses fewer workers per construction dollar—these are different kind of projects that typically are more capital intensive than standard home building.

More significantly, the rapid decline in the value of residential permits, which fell by a third over 2006, was not offset by any increase in non-residential spending.

Public spending may begin to pick up as a result of the various infrastructure initiatives—but this money still needs to be collected, distributed, and bid on by various companies. This is not a quick process. By the time the funds do kick in, the worst of the damage to the economy will already have been done. And the benefits of infrastructure spending will not be seen at all if the infrastructure funding is somehow diverted for more immediate needs in the fiscal crisis that is likely to be coming to California.

## *The General Business Outlook*

The outlook for the business (non-housing) economy is decent. We can expect the cooling U.S. economy to have a downward impact on exchange rates, which is good news for an export-oriented economy such as California's. And our manufacturing sector looks solid from a revenue and profit perspective. The solid performance of the manufacturing sector, combined with a lack of buildup in employment since 2001, will reduce the impact of slowing growth in the state by limiting the potential for job losses in secondary employment in manufacturing. (Such job losses could make the already bad real estate markets look downright horrible, as in the early nineties when the aerospace industry collapsed.)

Still, there are some serious risks. It is clear that slowdowns in real estate will have a negative influence on consumer spending, which in turn can depress various sectors in the state, including retail, wholesale, and some service sectors, such as leisure and hospitality. The full effect of these downward pressures remains to be seen. Also significant is the potential negative toll of another state fiscal crisis—both in terms of direct cuts in government spending and potential regulatory and tax uncertainty in the state. Meanwhile, the state is saddled with some of the highest home prices in the nation while it lacks workforce housing. These problems weigh heavily on businesses looking to recruit workers from out of state and will remain a drag on growth in the near future.

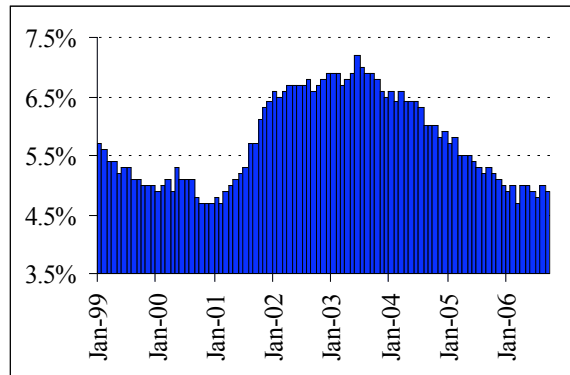
## State Employment

There have been many mixed signals in California labor markets in 2006. On the positive side, the unemployment rate remains at a very low 5 percent in the state. To put this in perspective, in mid-2000 at the peak of the tech bubble the unemployment rate had dropped to a very low 4.7 percent, in a labor market that was arguably overheated. This time there is little evidence of a similar problem.

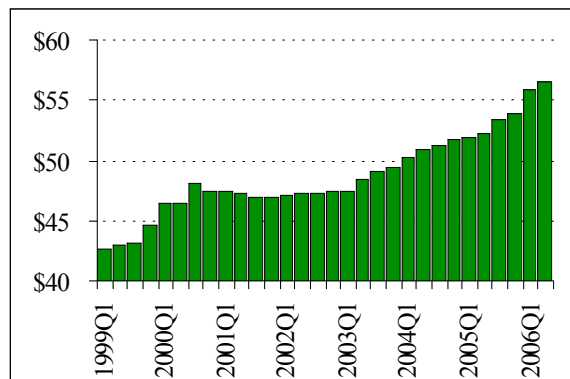
Overall worker income grew by 9 percent (nominal) over 2005-2006 (second quarter to second quarter), again the best showing since 2000. On a per worker basis, growth was about 8 percent. Even with rising energy prices, California workers saw a substantial increase in their buying power.

Yet even as individual workers have enjoyed solid labor markets, California overall saw a slowdown in employment growth in 2006. On the payroll side, employment grew by a paltry 0.9 percent (seasonally adjusted annualized rate). In 2005, the state saw growth rates of 2 percent. The lower rate in 2006 was mostly due to an unusual slowdown in employment during the summer.

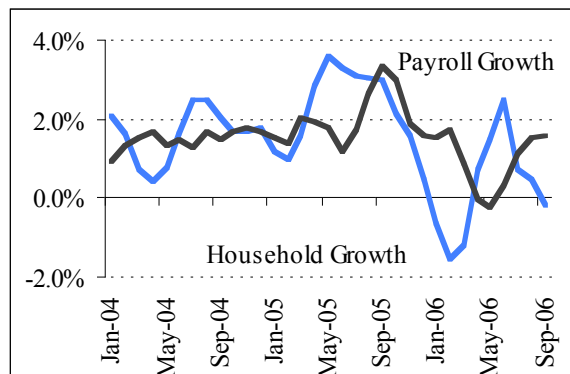
## California Labor Market Indicators Unemployment Rate (SAAR)



## Per Worker Wage Income, \$1000's SAAR



## Employment Growth, SAAR



Source: Bureau of Labor Statistics

## *Measurement Problems*

During 2005-2006, payroll employment experienced upward revisions with the new benchmark adjustment. This result is not surprising in an economy that is in the midst of recovering from a major downturn, as the Current Employment Statistics (CES) survey used to measure employment on a month-to-month basis misses employment driven by the creation of new firms during the year. The benchmarking process catches these jobs. Over 2005-2006, the update process has added about 0.5 percent to overall job growth. By this measure, things may be better than we think, and the income numbers would tend to support this possibility.

However, our other major measure of employment in the state—data from the Current Population Survey (CPS) often termed the “household survey”—is not

indicating that a major revision is in order. The CPS numbers are based on direct interviews with workers, rather than records of a fixed subset of firms, and thus tend to pick up what the CES

### ***Are the Household Revisions Real?***

It is clear why the payroll numbers were revised upward in 2005, given the new-firm bias of the CES program. It isn't clear why the household numbers were revised downward so sharply with the last benchmark. The household numbers are adjusted to state estimates through the use of population weights. A change in the weights will cause an increase or decrease in the total number of workers in the state. These weights were reduced in 2006, even though California continues to see strong population growth.

The revised 2005 benchmark household numbers showed a drop in the participation rate in California (the percent of the working-age population actually in the labor force), something that would seem highly unlikely in a state with a tight labor market, rising incomes, and a population that continues to see growth in the number of low-skilled immigrant families who often need two incomes to make ends meet. Instead, it seems that the change was made simply because there was an uncomfortably large and growing gap between the household and payroll series.

More likely the household numbers in reality reflected the continued growth of the informal sector—those jobs that are not easily counted in the payroll numbers for any variety of reasons. It is interesting inasmuch as we may expect to see future upward revisions in the household numbers if the cooling housing market has a negative impact on this informal part of the workforce, as it likely will, given the number of new non-payroll jobs that have formed in construction, real estate, and other home services in the midst of the real estate boom.

payroll survey may miss. Over 2005-2006, the numbers from the household survey grew at a much faster pace than the payroll numbers—indicative of the undercounting issue on the payroll side. This time it is quite the opposite—with the household survey numbers growing at a substantially slower pace. Last year, before the benchmark revisions, the two series showed a 3 percent growth rate for household employment and a 1.4 percent rate for the payroll numbers respectively. When revised, the two series were re-estimated at 2 percent each. This time it is reversed at 0.3 percent and 0.9 percent, respectively.

### *Two Basic Segments*

The California economy can be broken into two basic segments: an external sector that produces products and services to buyers outside the region, and an internal sector that sells products and services to those within the region. The internal sector, including retail, construction, healthcare, and similar sectors, has

### **California Payroll Jobs by Sector**

Seasonally adjusted growth rates, annualized for 2006

Source: California Employment Development Department

Sector	Jobs	Growth SAAR		Contributions		Contr. Shift
	Sep-06	2005	2006	2005	2006	
<b>Total</b>	<b>15,414</b>	<b>2.0%</b>	<b>0.9%</b>			
Information	481	-1.9%	2.9%	-0.06%	0.09%	0.15%
Non-Durables M	551	-0.8%	1.5%	-0.03%	0.05%	0.08%
Government	2,452	1.1%	1.5%	0.17%	0.23%	0.06%
Management	222	-1.5%	0.3%	-0.02%	0.00%	0.03%
Transport	493	0.1%	0.9%	0.00%	0.03%	0.02%
Educ / Health	1,620	1.7%	1.8%	0.18%	0.19%	0.01%
Durables M.	959	-0.8%	-0.9%	-0.05%	-0.06%	0.00%
Other	522	2.3%	1.3%	0.08%	0.04%	-0.03%
Wholesale	685	2.2%	1.2%	0.10%	0.05%	-0.04%
Professional	986	4.0%	2.3%	0.25%	0.14%	-0.10%
Leisure	1,520	3.1%	1.9%	0.30%	0.19%	-0.11%
Financial Act.	945	2.8%	0.9%	0.17%	0.06%	-0.12%
Retail	1,667	1.5%	0.4%	0.17%	0.04%	-0.12%
Admin Support	997	3.3%	1.0%	0.21%	0.06%	-0.15%
Agriculture	375	4.7%	-3.1%	0.11%	-0.08%	-0.19%
Construction	915	7.8%	-2.3%	0.45%	-0.14%	-0.59%

been driving overall payroll growth. This trend reversed itself in 2006, in large part due to the softening of the real estate markets. These internal sectors are starting to slow, even as growth in external jobs has improved. The external sector started to grow at a decent pace in the middle of 2004 after a number of years of languishing.

The biggest single shift in growth rates was in the construction sector. In 2005, this single sector grew by 7.8 percent and accounted for nearly a quarter of total job growth in the state. But in

2006, construction began what promises to be a long slide in the number of jobs. At this writing, it has shrunk by 2.3 percent. This one sector accounts for half of the slowdown in growth. The direct impact of housing on the economy can already be seen.

Additional signs are also ominous. Other internal jobs have seen a sharp slowing in their growth rates, also contributing to the overall slowdown in employment growth. Jobs in administrative support, which includes temporary employment services, slowed from 3.3 percent to 1 percent, as has growth in financial activities, including real estate and mortgage banking (2.8% to 0.9%), retail (1.5% to 0.4%), and leisure (3.1% to 1.9%).

Fortunately for the state, the external economy has continued to keep apace. Non-durable manufacturing has been adding jobs at a solid pace even as durable manufacturing has stabilized. The information sector, which includes motion pictures, has also been adding jobs at an accelerated pace. The public sector has seen solid growth and currently contributes about a fourth of the new jobs added to the state. Manufacturing and information jobs are notoriously unstable, however. If these sectors turn back, as they are liable to do, the economy will yet again drop to a zero growth category.

**California Non-Farm Payroll Growth by Region**

Source: California EDD

	Current Sep-06	2006 % AR	2005 % AR	Change
California	15,039	1.1%	2.2%	
San Francisco	963	2.0%	1.3%	0.7%
San Jose	880	1.5%	1.0%	0.5%
East Bay	1,061	1.7%	1.4%	0.3%
Los Angeles	4,077	1.2%	1.2%	0.1%
San Diego	1,305	1.4%	1.7%	-0.3%
Ventura	298	1.6%	2.1%	-0.5%
Orange County	1,514	1.4%	2.2%	-0.8%
Inland Empire	1,256	2.5%	4.1%	-1.6%
Santa Barbara	174	0.9%	2.4%	-1.6%
Sacramento	902	1.2%	2.8%	-1.7%
Bakersfield	230	3.2%	5.2%	-2.0%
Fresno	293	-0.9%	1.6%	-2.5%
Santa Rosa	185	-2.3%	2.2%	-4.4%

These same trends have shown up in the regional data. Those centers of the external economy—primarily the Bay Area, but also Los Angeles to some extent, remained relatively stable, or have seen an acceleration in their growth rates. Those economies that have been driven forward by housing, on the other hand, have seen a sharp slowing of their growth rates. The Inland Empire

and Orange County, for example, saw slowing in the pace of job growth in the past (only to have substantial upward revisions in the new benchmark).

### *The Near-Term Job Outlook*

In summary, the 2007 employment outlook appears mediocre to poor for the state. A slowing economy will reduce the pace of job growth further, with construction and financial activities at particular risk. Unemployment will likely begin to rise as well, as the informal sector—driven to a record size in large part by the booming real estate economy—starts to shrink. These two sectors alone can cause employment growth to come in at significantly below its average pace. At least 200,000 construction jobs are at risk as the housing market continues to cool and as homeowners are unwilling to invest in housing upgrades in a market that does not promise such high returns.

The potential impact on real estate and mortgage banking is less clear, but equally worrisome. If mortgage foreclosures spike up, the activity generated by the market liquidity will support some jobs even as the real estate market sinks even farther. But in that case, the potential for spillover to the rest of the economy is larger, as it is just this type of liquidity that allows prices to fall faster and thus increase the impact of a cooling market on consumers. In this case, other internal jobs related to consumer spending will be at even greater risk.