

State Economy Lags Behind National; Housing Mortgage Problems Main Cause

U.S. Economic Slowdown

The economic statistics continued to deteriorate over the past three months. In particular, growth in U.S. gross domestic product (GDP) dragged on at an anemic 0.6 percent annual rate, the same pace as in the fourth quarter, and well below the 4.9 percent pace of third quarter 2007.

New home construction continued to plunge, subtracting about 1.2 percentage points from GDP growth. Elsewhere, consumer spending slowed to a 1 percent annual rate of growth.

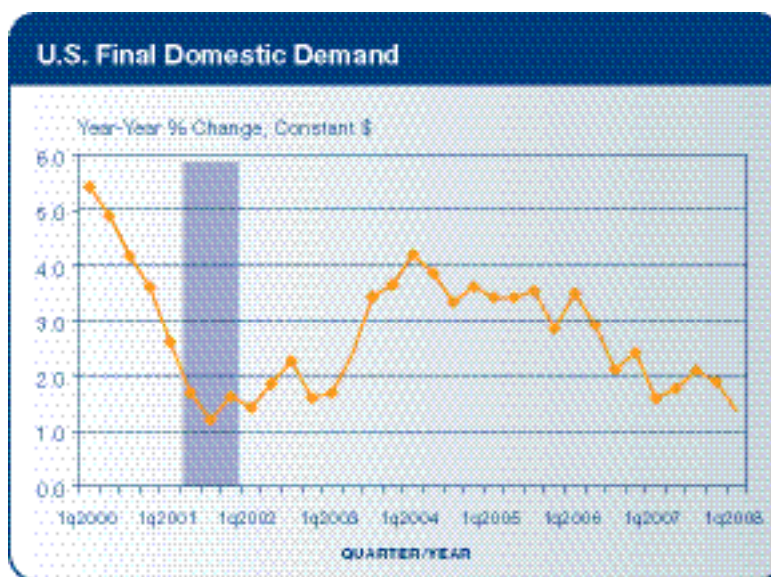
Business-fixed investment spending actually declined by -2.5 percent, while business inventories increased a bit after falling sharply during the fourth quarter. Government spending held stable, increasing by 2 percent.

Net exports improved slightly. Export growth edged down to a still-healthy 5.5 percent annual rate. Meanwhile, imports increased modestly (by +2.5 percent) after declining by -1.4 percent in the fourth quarter.

As shown in the chart, final domestic demand, which excludes changes in inventories and net exports, grew by 1.4 percent last quarter compared with first quarter 2007, down from the 2 percent pace of the previous three quarters and the slowest quarter since the 2001 recession.

Other news also has been downbeat. Monthly increases in non-farm payroll employment, which averaged +91,000 net new jobs during 2007, dropped to the negative territory, with an average decline of -77,000 net new jobs during the first three months of 2008.

During 2007, weakness had



spread from residential construction to manufacturers and distributors of housing-related products (doors, windows, shingles, furnaces, etc.) to the financial sector — first, to mortgage finance and then more broadly to Wall Street, and beyond.

In 2008, employment growth has slowed in other — presumably unaffected — industries as well, reflecting employers' uncertainty and cautious attitudes. Meanwhile, the nation's unemployment rate moved up from 4.6 percent in June to 5 percent in December and 5.1 percent in March.

Consumer sentiment has plunged to its lowest level since 1982. Sentiment usually reflects current labor market conditions and recent trends on the inflation front. Both are problematic at present.

Energy prices are reaching for new highs, with crude oil testing at \$115 per barrel and gasoline prices soaring above the \$3.80 per gallon level in California.

The increase in grocery prices has been just as conspicuous. Rising prices for food and energy threaten to eclipse

the growth in disposable income (indeed, they did so in March) and limit consumers' discretionary spending options.

It's no surprise then that household spending slowed sharply in the first quarter, especially for durable goods, placing the U.S. economy at real risk of recession.

Concerns about recession have grown as the incoming data worsened. Most economic forecasters have reduced their projections for 2008, with a significant proportion 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 more than 50-50. Thus far, however, the steep production and employment declines that usually accompany a recession have been confined to specific industry sectors — housing, manufacturing and finance. Outside of these sectors, the economy is doing reasonably well, though businesses are cautious and limiting their own hiring and investment spending.

Interest Rates/ Financial Markets

The Federal Open Market Committee (FOMC) dropped the fed funds target rate in several steps from 5.25 percent in August 2007 to 2 percent at its April 30, 2008 meeting, a swift decline not seen since the 2001 recession.

The Fed has several concerns: an upsurge of extreme instability in global financial markets beginning around midyear 2007 and fears that volatility and tight credit conditions could spread to the real economy, already struggling with a

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severe downturn in housing activity.

Global credit markets, which “seized up” in August, are still far from normal despite vigorous actions by central banks to increase market liquidity and ease interest costs. The level of short-term has fallen, but spreads are still high, though narrower than during last fall’s episodes of extreme market stress.

An upsurge in inflation pressures complicates matters for policymakers. Most energy, industrial and agricultural commodity prices are high and rising rapidly, boosting costs for manufacturers, farmers and all businesses that operate fleets of trucks, locomotives, aircraft or ships. Many of the affected firms are attempting to pass the higher costs onto their customers.

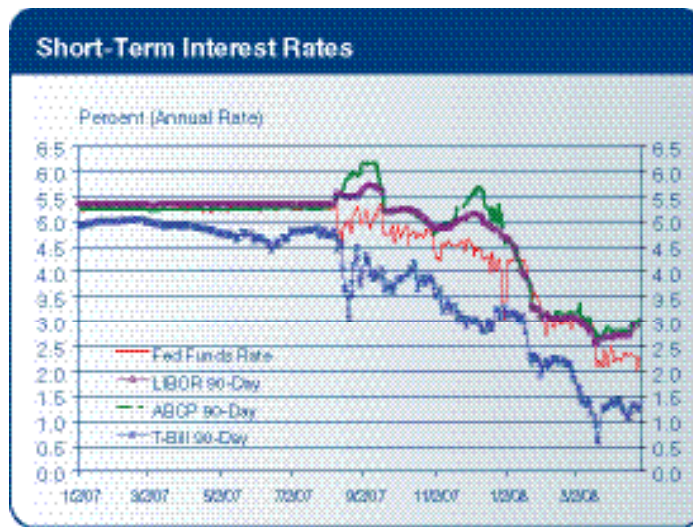
As fighting inflation is one of the Fed’s two primary charges (the other is maximizing employment), members of the council believe that intensifying inflation pressures likely will limit the Fed’s easing options. Thus, the Fed may choose to pause for a while to determine if capital markets and the economy can manage on their own in light of all the expansionary monetary and fiscal policy actions taken to date.

California Economy Lags

California continues to underperform the rest of the United States by most economic indicators, largely as a consequence of its extensive housing-mortgage problems.

Non-farm employment, for example, was down by -0.1 percent over the year to March 2008 in California, while employment in the rest of the nation increased by 0.4 percent over the same period. (In contrast, job counts grew by 1.2 percent in both cases between March 2006 and March 2007.)

Employment actually declined over the last 12 months in the state’s construction, mortgage-related financial, manufacturing, retail trade, real estate



and information sectors. On the plus side, job growth leaders included education and health, with payrolls up by 2.5 percent; professional, scientific and technical services (+2.5 percent); and leisure and hospitality (+1.2 percent).

Still, the state’s unemployment rate rose from 5 percent in March 2007 to 6.2 percent in March 2008. This was a bigger increase than experienced by the United States as a whole so the margin between the state and the nation widened from 0.6 percent to 1.1 percent.

Exports

Exports of goods made in California are providing a much-needed boost to the state’s economy. Total state exports grew by 5 percent during 2007. Exports during the first two months of 2008 — the latest data available — increased by 11.5 percent.

The largest category of exports is high-tech manufactures (computers, peripherals and so forth), which edged up by just 0.1 percent in dollar terms. However, exports of transportation equipment soared by 28.6 percent.

Exports of other important California-made products also grew rapidly, like chemicals (up by 11.9 percent), miscellaneous manufactures (+19.8 percent), and agribusiness products (farm produce, livestock, fish and processed food products), which increased by 24.5 percent. The one major negative was a -12.6 percent decline in exports of non-

electrical machinery.

Personal income earned in California increased by 5.8 percent during 2007 compared to 2006 (latest data available). U.S. personal income grew by 6.2 percent over the same period. Problems in the state’s finance and construction sectors accounted for most of the difference.

More recent California information can be inferred from state personal income tax payments. The California State Controller reports that personal income tax receipts increased by just 2.7 percent during the first three months of 2008 compared with the same period of the

previous year, suggesting that income growth has slowed.

Also, Department of Finance reports show that corporation and sales tax receipts both have been running below expectations. The state government will have to address a severe budget crunch in coming months.

Regional Performance

Among the state’s major metro areas, regional economic performance is mixed. For any area, the net amount of local job growth or decline depends not only on the importance of the residential and mortgage-related industries to the local economy, but also on how the area’s other leading sectors are performing.

Non-farm employment growth between March 2007 and March 2008 was positive in the San Francisco Area, Bakersfield, Stockton, San Jose and Fresno. At the other end of the scale, employment declines have been most severe in Ventura County, Riverside-San Bernardino and Orange County, with lesser declines in Oakland-Contra Costa, Modesto and Los Angeles.

Job counts in the Sacramento and San Diego areas have shown little change over the 12-month period despite marked declines in residential construction activity.

The San Francisco and San Jose areas continue to outperform other regions of the state. In large part, this reflects the

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renewed strength of the Bay Area's 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 plays a more important role in the Oakland/Contra Costa metro area, and many finance industry jobs have disappeared, especially in Oakland and San Francisco.

In Southern California, the motion picture industry hasn't returned to normal even though the writers' strike has ended.

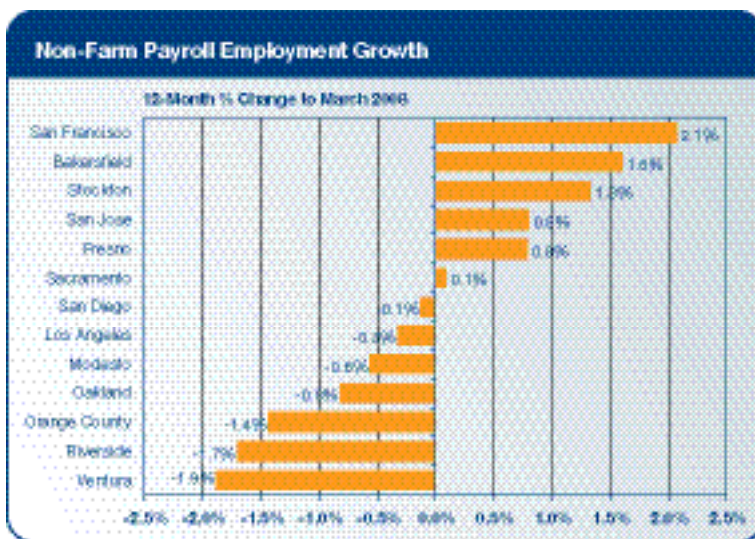
Negotiations with the Screen Actors Guild started early — a hopeful sign — but the timing of the industry's recovery is not clear.

Elsewhere in Los Angeles, the strongest industries are tourism, technology and professional business services. Residential construction is quite soft throughout the region, with activity especially slow in the Inland Empire. Orange County has taken substantial hits in its mortgage banking industry, and tourism is somewhat sluggish. San Diego's economy is moving sideways, with growth in tourism, education and health care.

Agriculture and Resources

California's agriculture sector is holding up well. Prices are high for most products and exports are growing nicely. Dairy prices are expected to turn down toward year end, as more young cows are coming into production. However, costs are rising rapidly, especially feed grains for livestock and energy of all types. Also, the minimum wage was raised in January, so farms will experience higher labor costs in 2008.

Profitability varies widely by product. As examples, dairy and nut producers are doing well, but cattle and poultry margins have been squeezed. 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

Water supply will be an important concern in 2008. The weather was well-behaved early in the year, but the rains ended early. It looks like the state's water supply overall will be a little below normal this year. Still, the drought in the Colorado River Basin has broken after eight years. And water levels are rising in most reservoirs, though the water actually in storage remains well below average.

The major issue for 2008 is how much water will be permitted to transit the Delta. Allocations to parts of the Bay Area, Southern California and the San Joaquin Valley will be sharply reduced this year — perhaps by 30 percent or more — following several court decisions to curtail Delta pumping in order to protect the endangered Delta smelt and salmon.

Even for farms with adequate annual water allocations, there could be temporary problems if the pumps are shut down at the "wrong time" of year for their particular crops.

Real Estate: Housing Crash

The downturn in housing has worsened over the last three months. Here are some of the grim statistics for the resale home market:

- Existing single-family home sales in California plunged by -24.5 percent over the year to March 2008, while condo sales were down by -45.5 percent.

- Prices also have fallen, with the median price of single-family homes sold in March 2008 down by -29 percent compared to March 2007.

- The number of homes available for sale represented 11.6 months supply (at March's sales rate), compared to 7.6 months a year earlier.

The declines in California's home sales and prices are exacerbated by the scarcity of jumbo mortgages on the one hand and a large number of real estate owned (REO) homes on the other. Many primary mortgage lenders are limiting risk by

offering only traditional "conforming" mortgages, which top out at \$417,000, not enough to purchase a typical home in many California communities.

The conforming limit has been boosted temporarily (through year end 2008) by varying amounts depending on median home prices. However, the all-important details required to handle the new (jumbo-conforming) mortgages in the secondary market have not been worked out yet, and loan fees are reportedly high.

Several areas in California have experienced high foreclosure rates, and lenders have been repossessing large numbers of homes. Usually, these homes are then placed on the market priced for a quick sale, that is, at a discount below prices of other comparable homes in the area. Bank-owned REO homes account for a significant fraction of for-sale homes in several markets (up to and above 50 percent in some cases) and are said to be pushing prices down.

Residential construction has continued to plunge across the state. A total of 112,800 new home construction permits were pulled during 2007, down by -31 percent from 2006 (and by -46 percent from the 2004-05 peak). Total housing permits were issued at an annual rate of only 68,000 units during first quarter 2008.

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Single-family homes continue to be most affected. Some 68,000 new single-family permits were issued during 2007 (down by -37 percent from 2006). The first quarter annual rate for new single family homes was just 35,100 units, down by -48 percent from 2007.

As in the resale market, many new home builders have large inventories of mostly-completed-but-not-yet-sold homes. Construction of new homes is dropping fast and effective prices are falling, both of which will help to clear out the unsold inventories. However, this process will take a while. Industry observers do not expect any significant improvement before 2009, with some areas not reaching bottom until a year later.

Commercial Real Estate

In contrast to residential, most of California's commercial real estate markets have held up fairly well. Demand for office space has slackened, reflecting the mixed trends expected for employment growth in office-based industries. Vacancies are high and rising in Orange County, Sacramento and San Diego, and rents look weaker there than elsewhere.

The Bay Area appears to have the best employment prospects, though even here cautious hiring may cause vacancy rates to rise. Industrial markets look reasonably solid. San Jose and the East Bay are expected to do well, and vacancy rates are extremely low in Los Angeles County. Again, vacancies may tick up if activity slows substantially.



Financing has become much harder to obtain for most types of new commercial real estate projects. The construction pipeline will empty out gradually, limiting the amount of new supply coming into already slowing markets.

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.

Continued volatility in global capital markets could reduce the willingness of financial institutions to take on mortgage-related debt and also to engage in ordinary business and consumer lending, thereby worsening the current credit crunch and slowing business and household spending.

Rising energy and food 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. Higher grocery prices have the same effect.

Consumer surveys show confidence is dropping, reflecting numerous media reports on both subjects.



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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