

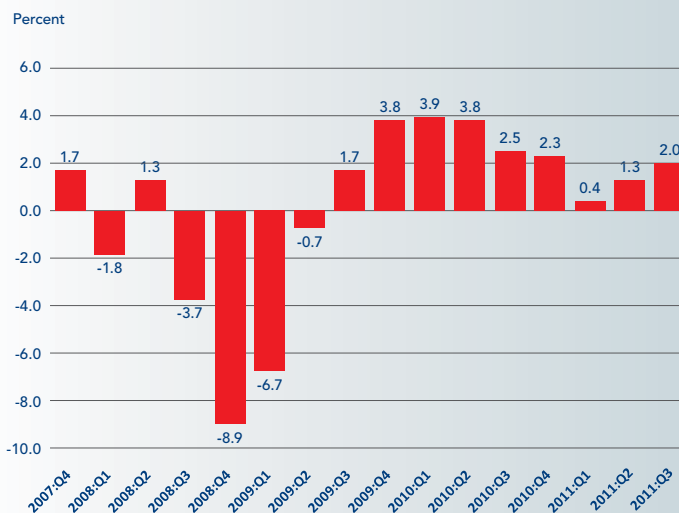
# Global Economy Better than Headlines Say; State's Economy Continues Slow Recovery

When the California Chamber of Commerce Economic Advisory Council met on the phone in early November, the headlines were full of anxiety about the European sovereign debt crisis and its potential contagion effects on U.S. banks and the U.S. economy. Meanwhile, anxiety about slow economic growth in the U.S. continued, but eased somewhat as more data was released. The new consensus now is that the fears of a double-dip recession are overblown.

This report will start by looking at the international situation, then cover the evidence concerning a continued slow U.S. economic recovery, highlight some surprising California trends, and then discourse about recent agricultural trends, tourism, housing, and water and electricity issues. The main “take aways” coming out of the discussions of the Council’s distinguished economists are the following:

- The European crisis is serious, but its interpretation in the media is exaggerated and sensational. Ultimately, the Europeans will muddle through this.
- Evidence is mounting that the U.S. economy is back to at least a 2.5% growth path following a sluggish spring and summer. Positives are small improvements in the labor markets, exports, modest growth in consumer spending and increase in business fixed investments.
- Job growth in California has improved following its summer doldrums. Although it is still slow, overall job growth in high tech urban centers is faster than the average statewide growth, pointing to a regional growth bifurcating the east and west of California.
- California agricultural trends have been generally positive, driven to a large degree by a strong export demand.
- Tourism is up, propelled by modest domestic growth and increased business

### Real GDP Growth in the United States



Source: U.S. Bureau of Economic Analysis, HousingEcon.com

from foreigners. More vigorous international travel to California is hampered by the tight visa policies of the U.S. government.

- Housing is still languishing with very little differentiation among regional submarkets. Activity in terms of volumes and new housing production is still in deep freeze. Tight credit availability is not helping. However, urban coastal areas are poised for recovery, helped by improving economic conditions, remaining homeowner equity, and historically high affordability.

- Water and electricity concerns have abated. The drought has been broken. Long-term problems, however, remain, such as the levee issues in the Delta.

Looking forward to 2012, continued export growth will favor California’s coastal urban areas. Interior California will continue to benefit from a good agricultural business, but sorely miss economic activity that used to come from new housing production and the big affordability migration waves of the past.

## Europe/Other International Issues

In general, it must be said that the Euroland is a commercial empire. The main European powers have long since abandoned military empire building. The responses of the leaders of Europe cannot be understood without keeping this in mind. While there are rumblings about the cost of the sovereign debt bailouts, the Europeans have no other choice but to maintain the euro and its survival if they want to stay relevant on the world stage.

In this context, it is important to note that Greece, for example, is tiny from an economic standpoint. Its economy is just half the size of the San Francisco Bay Area. Also, if it were to exit

the euro and re-establish the drachma, the entire country would be in debt, both the public and private sector debt, and Euroland could be on the hook for that.

Fortunately, the recent developments concerning the Greek crisis suggest that this will be avoided. New austerity programs are being seriously considered and a new prime minister, Lucas Papademos, will spearhead austerity measures in exchange for European bailout money. A different issue is Italy, which was the focus of financial markets recently. This led to the resignation of the prime minister, Silvio Berlusconi. The new prime minister designate will soon form a technocratic cabinet to deal with debt crisis. Much has been said about the 120% public debt of Italy and its bond yield reaching so-called “critical” levels of 7%, which is supposed to be unsustainable. However, Italy has been having this public debt level for 25 years now and, according to a recent report by Fitch Ratings, long-term bond yields will become unsustainable only if they reach the 15% to 20% level.

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Meanwhile, Ireland, another debt crisis country, has been getting its act together, cutting its budget deficit. Spain, which could be next in line, actually has no public debt problem. Its gross public debt is just 68%, lower than the 96% of the Eurozone or the 101% of the U.S. Its problems are associated with a massive housing bubble and its subsequent bursting.

Much has been said about European credit default swap spreads, which some have called “mind boggling.” However, outstanding net notional values of European credit default swaps are tiny and not relevant. Even the so-called weakness of the euro is a much smaller issue than it is made out to be. When the euro started, the euro to U.S. dollar exchange rate was 1.17; now it is 1.35.

Overall, therefore, the European debt crisis is less severe than pundits proclaim on major financial TV channels. The euro will survive. To be sure, Euroland’s gross domestic product (GDP) growth is likely to slow from 1.7% in 2011 to 1.2% (or slightly less) in 2012, with growth slowing in France and Germany. However, this slowdown will not be catastrophic. Economic growth in Asia will be a strong 5%, with China slowing somewhat and Japan turning to positive growth again after a bad 2011 performance. Overall, the world GDP will be 3% in 2012, unchanged compared to 2011.

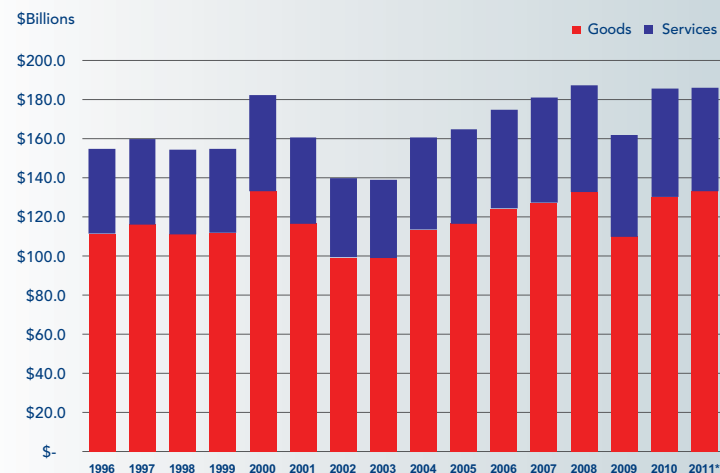
This global outlook and the more measured interpretation of the European debt crisis, which was presented to the Economic Advisory Council by Sheldon Engler, suggests continued moderate growth for California and the U.S. next year.

### U.S. Economy

Recent economic evidence for the U.S. supports the notion that there will be no double-dip, but that growth is and will be subpar to previous recoveries. Third quarter real GDP rose 2.5%, a pick-up from

**California's Export Trade: 1996–2011**

In 2005 Dollars



Source: Jock O'Connell, U.S. Census Bureau Foreign Trade Division

1.3% in the second quarter 2011. The acceleration of real GDP reflected a pick-up in personal consumption expenditure (up 2.4% in quarter three 2011 versus 1.3% in quarter two 2011) and in non-residential fixed investments (16.3% versus 10.3%), and an improvement in the net export situation, which contributed 0.22% to GDP growth. Real final sales of domestic product, which is GDP growth less the change in private inventory, increased 3.6% in third quarter 2011.

Recent monthly statistics point to further growth in the quarters ahead:

- The number of people filing for unemployment benefits dropped to 397,000 recently, the lowest since April this year.
- Monthly U.S. job growth was 80,000 in October, which is not great, but figures for August and September were revised upward—102,000 more jobs than originally reported. Sequential private sector job growth was 104,000 in October this year.

● Even mass layoffs were stabilizing in September as employers laid off slightly more than 153,000 workers.

● Although confidence challenged, consumers spent 0.5% more in October than in September. The increase, while still weak, was driven by spending on automobiles and consumer electronics.

However, personal income growth in September was still a sluggish 0.1%, which makes the personal consumption figure even more remarkable.

● The U.S. trade deficit narrowed in September to the lowest level this year as exports surged to a record high. The shortfall shrank 4% to \$43.1 billion. The smaller September U.S. trade bill will mean bigger contributions to third-quarter GDP growth.

● Industrial production increased in the third quarter this year by 5.1% at an annualized rate. The total capacity utilization rate edged up to 77.4% in September, 1.7 percentage points higher than a year ago, but still 3 percentage

points lower than the long-run average. If capacity utilization rises more, new hiring will be necessary.

### California Economy Slow But Continues to Recover

The state gained a total of +233,700 non-farm jobs over the 12 months to September. Thirteen industry sectors and government recorded year-over gains led by administrative services; professional, scientific and technical services; leisure and hospitality; and health care. Two sectors reported employment declines: financial activities and other services.

Eleven of the state’s major metro areas reported year-to-year gains in non-farm employment over the year to September, while just two recorded declines. Leading the way were:

- the San Jose metro area (+3.1% over the year);
- Ventura (+1.7%);
- San Diego (+1.4%);
- Bakersfield (+1.3%); and
- Riverside-San Bernardino (+1.2%).

Job losses were recorded in Fresno (-1.0%) and Sacramento (-0.4%). Among the remaining areas, employment grew the fastest in Stockton and Orange County (+1.1% and +0.9% respectively).

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Oakland-Contra Costa and Modesto areas recorded the lowest growth (of +0.1% and +0.3%).

Overall, job growth seems to be more robust in urban coastal areas than the inland regions with the San Jose and San Francisco areas leading the way. The pick-up in job growth for the Inland Empire is an encouraging sign that the economic recovery in the California interior may take hold.

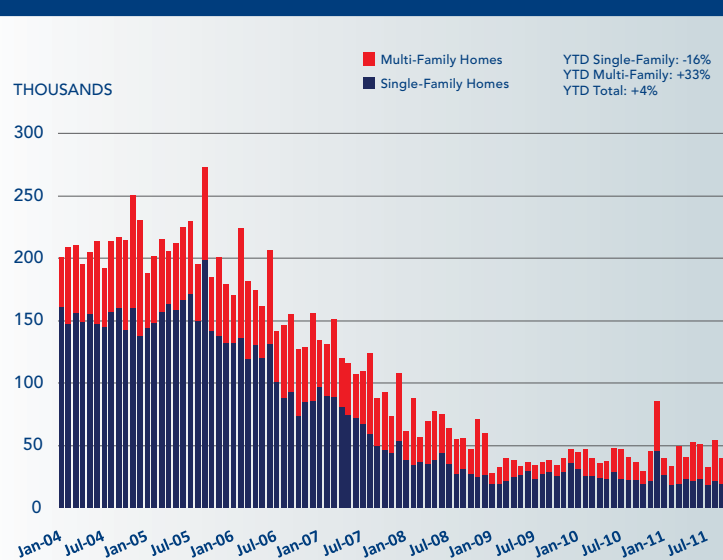
On a side note, it may interest CalChamber readers that California's annual job growth outpaced Texas in September in absolute (not percentage) terms. Even more remarkable is that the quality of job growth in California was vastly superior to that of Texas if one looks at wage levels by industry. California job growth has a much bigger emphasis on higher-paying industries than Texas, some of which are high tech, high value-added and export-oriented, a crucial industry make-up indicating a positive overall outlook for California if the global economy holds up as predicted above.

Meanwhile, non-farm employment increased in Southern California during the third quarter (on a seasonally adjusted basis), with gains registered in all six counties. Compared with September 2010, job gains were widespread in administrative and professional services, health care, and leisure and hospitality. Downturns were most pronounced in other services (personal and repair services and non-profit associations), financial activities and construction.

### **International Trade**

International trade flows through the area's ports continued healthy, but dipped below 2010 levels during the third quarter of 2011. The shortfalls continued to reflect Japan's disasters in March and American retailers' return to normal holiday stocking and shipping patterns (the shipping season started early in 2010). The dip in port traffic has had little noticeable impact on

**California Housing Permits** (Seasonally Adjusted at Annualized Rates)



Source: Construction Industry Research Board, HousingEcon.com

wholesale trade and the distribution centers in Orange County and the Inland Empire, which are seeing more business. The region's entertainment sector continued to recover in the third quarter, with increased local filming of feature films and commercials especially notable. The Southern California tourism sector also made progress, with hotel occupancies and room rates both rising (room rates did not increase during summer 2010).

Aerospace firms are mostly stable for the moment, but trimming defense-related employment and costs in anticipation of leaner times ahead (and following the final shutdown of the space shuttle program). The president's upcoming defense budget for fiscal year 2013 and forward is expected to lay out procurement declines in several programs of regional interest. On the other hand, production of commercial aircraft is revving up. Boeing plans to increase production of its popular 737 in 2012-2013, and deliveries of the new 787 Dreamliner and the 747-8 aircraft also are expected to rise.

### **Housing Still in Limbo**

California housing is still extremely sluggish. New housing production is es-

entially stagnant, although the multi-family sector has turned around lately, growing slightly more than 19% in quarter three 2011 on a year-over-year basis. The state's home resale market is still bouncing along the bottom, with essentially no regional differentiation. A major positive is historically high ownership housing affordability.

Looking forward, the faster trajectory in economic fundamentals in coastal areas should benefit the urban areas in Southern California and the San Francisco Bay Area next year. This will be supported by the fact that the housing system in those areas has a lot more positive homeowner equity than is usually recognized.

Furthermore, the forward-looking foreclosure fundamentals have also improved lately, according to delinquency information of the Mortgage Bankers Association, which still depict high delinquencies, but they have been dropping fast for many categories.

### **California Agriculture Improving**

The value of California agricultural production in 2011 is expected to have increased by 10%+, because of higher yields and/or stronger prices. Export demand helped strengthen market prices, as demand abroad increased with improving economies and the low value of the U.S. dollar. The value of California agricultural exports has increased 18% year-to-date.

While the livestock sector in California has struggled with high hay and grain prices, increasing production costs, beef and milk prices have hovered at record levels for much of 2011, driven by high export demand. Milk prices have recently declined from their highs because of softening domestic demand and increasing inventories. Grain prices have also fallen modestly, with concern about global growth and increased reports of higher grain production in other global regions.

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Poultry producers have been especially burdened by high feed costs.

Producers of vegetables, nuts, grapes and other fruits have generally enjoyed good production conditions and good prices. Even the producers of peaches, plums and nectarines had a good season in the latter half. Practically all harvests were one to two weeks late because of persistent wet, cool weather last spring. This resulted in considerable crop damage to grapes because of unseasonable freezes last spring and rains during the harvest.

Field crop producers were also challenged by delays in plantings and harvest. Yet, high prices for grains, hay and cotton have benefited most producers.

California growers were especially thankful for excellent water conditions in 2011. Abundant rains and snow packs helped replenish groundwater basins and provided for nearly full surface water deliveries in all regions. Current reservoir storage is significantly higher than this time last year and higher than historical averages in all regions, other than the Colorado River reservoirs, though the latter is much improved over last year. Agriculture surface water users expect to get full or nearly 45% deliveries next year, even if drought conditions return.

Agriculture labor availability continues to be ample, though there were some difficulties during the late harvest period, as poor weather threatened the harvest and other U.S. regions competed for the same workers. California fruit and vegetable producers are apprehensive about the availability of labor in the near term, because of the possible changes in federal regulations requiring more stringent verification of workers' documentation.

### California Tourism

California tourism has exhibited positive trends lately. Domestic airline travel is likely to grow 3% to 4% this year. Both car rentals and motor coach rentals are up this year. Leisure bus trips have increased 2% to 4%. Hotel occupancy has risen 5% to 6% and international visits to California have increased. Strong demand positives are travel activity from China, Europe and Canada. A major risk for all

tourism, however, is a proposed \$100 federal surcharge per flight in the U.S. for a security fee. Other hindrances include a cumbersome visa-issuing system abroad, which keeps tourists at bay. A possible positive for tourism is a new federal travel promotion program, which could particularly benefit California.

### Water and Electricity Conditions Fine

Last year's wet year has replenished both in-state reservoirs and those on the Colorado River. The Colorado River still has very low reservoirs, but compared to recent years they are much improved. The current long-range forecast is predicting a wet winter for Northern California, which is where most of the state's water comes from. However, there is still a risk that the precipitation band would move north and leave the state dry, but there are no short-run supply issues.

Electricity demand is still reduced by the recession's aftermath, so supplies are good, even though permitting and financing for some of the planned renewable generation is progressing somewhat slower than had been hoped.

### Cap-and-Trade Program

On October 20, the Air Resources Board (ARB) adopted a cap-and-trade program that will require electric generators to purchase permits to emit greenhouse gases. These permits will be purchased through an auction that will be run by the ARB. The revenue from the sale of the permits is supposed to be used to help the consumers adjust—by either giving them money or, for example, funding conservation or renewables programs. The details have not yet been ironed out.

People (including the Legislative Analyst's Office) are concerned about the complicated nature of the market, and worry that it could be susceptible to manipulation, perhaps with a repeat of the electric market start-up fiasco. If this did happen, it should be less of a problem this time around because the possible uses of the revenues could protect consumers from the worst of a market meltdown. However, under the current regulation, some particular groups could be hard-hit. The permits will be required as of January 2013.

### Delta

Delta issues are continuing to cause concern. There are ongoing problems with environmental decline and restrictions on taking water from the Delta. In addition, the levees on the Delta islands are at risk of failure, either through storms, earthquake, or other problems. A large failure would put much of the state's water supply at risk, and Sacramento has been ranked the second city in the nation for flood risk (New Orleans is No. 1).

### Summation

The global economic outlook is better than the hoopla surrounding the European debt crisis suggests. This will help California businesses, which are heavily export-oriented. Regionally, economic growth is likely to be higher in coastal urban communities than in the interior regions of California. This will trigger an early recovery in coastal housing markets and result in increases in their housing production, particularly in the multi-family sector. Tourism and agriculture growth could accelerate next year, and water and electricity concerns have abated.



*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 Sidhu, vice president and chief economist, Los Angeles County Economic Development Corporation. December's report was written and presented by council member Gerd-Ulf (GU) Krueger, founder and principal economist for HousingEcon.com.*

*Publication of this report is a project of the California Foundation for Commerce and Education.*