California Economic Overview
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Contents

Key Findings

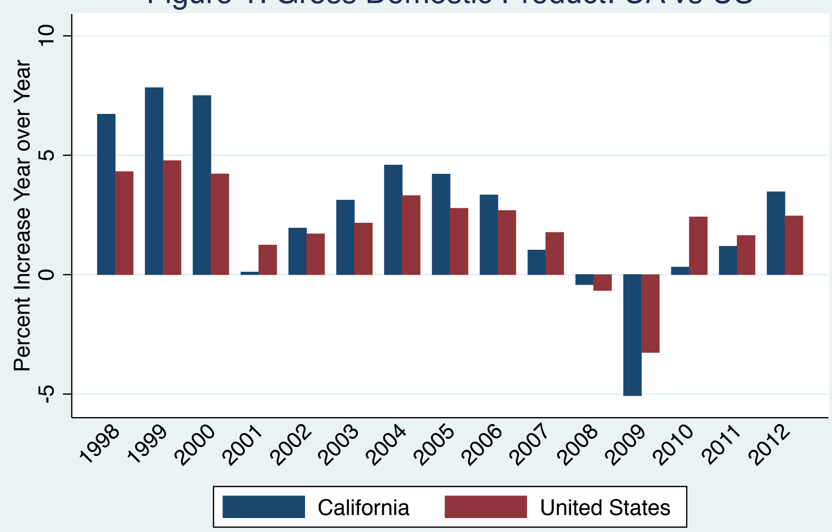
- In 2012, California's GDP and overall employment growth exceeded that of the rest of the country. In 2013, things are looking more average.
- California's unemployment rate has fallen rapidly, but remains high relative to the nation at 8.9%. Unemployment rates remain in the double-digits through much of the Central Valley and are just under 10% in the Inland Empire—two geographies that experienced particularly large housing bubbles.
- Employment growth in California through the recovery has included a larger percent of high wage jobs than nationwide, but declines in Federal and local government employment have significantly hindered recovery.
- Median home prices in August, 2013, were up nearly 30% from the previous year. Residential construction has started to return. Housing markets are an important part of recovery statewide.
- Long associated with international trade, California's trade flows are lagging behind the rest of the nation's, especially in computer and electronic products, a mainstay of California's exports.
- The state government budget is returning to a more normal state of affairs. However, it is doing so at a significantly reduced level of revenues and with expenditures significantly lower on key economic drivers—including education.
- Going into 2014, prospects for economic growth in the state are good. This, however, depends crucially on the handling of affairs in Washington, DC, as it does for most other states.

California Outperforms Nation…Normally

Over the course of the last 15 years, California has outperformed the rest of the nation in good times and underperformed in bad times. This often occurs because of California's frontier industries—in particular technology firms based in Silicon Valley. But sometimes this results from more mundane sectors such as housing.

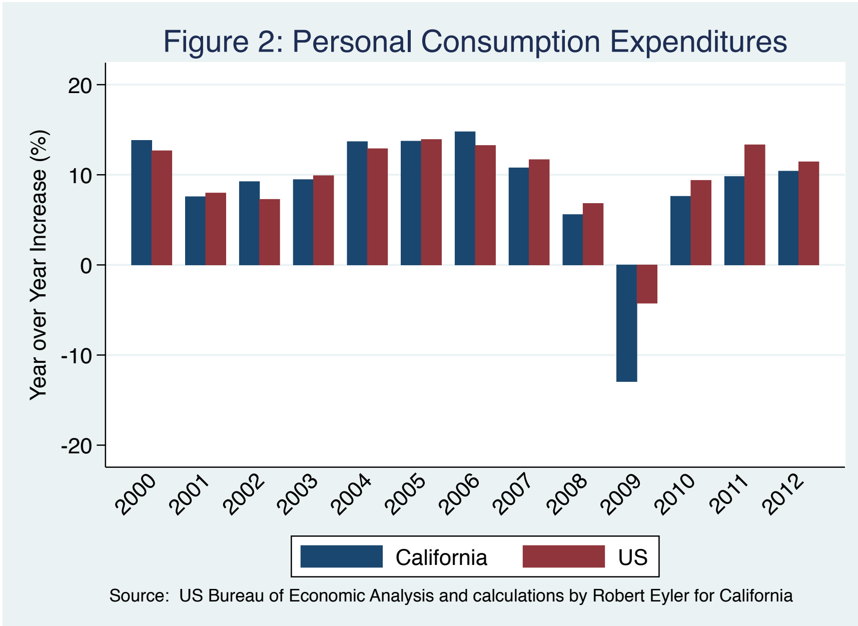
Fortunately, good times are more common than bad. During nine of the last 15 years, California's GDP growth exceeded that of the rest of the country (Figure 1). This happened despite the fact that California sat front and center in the two most recent recessions: the technology-driven Dot Com Recession of 2001-02 and the housing-led Great Recession of 2007-2009.

Figure 1: Gross Domestic Product: CA vs US



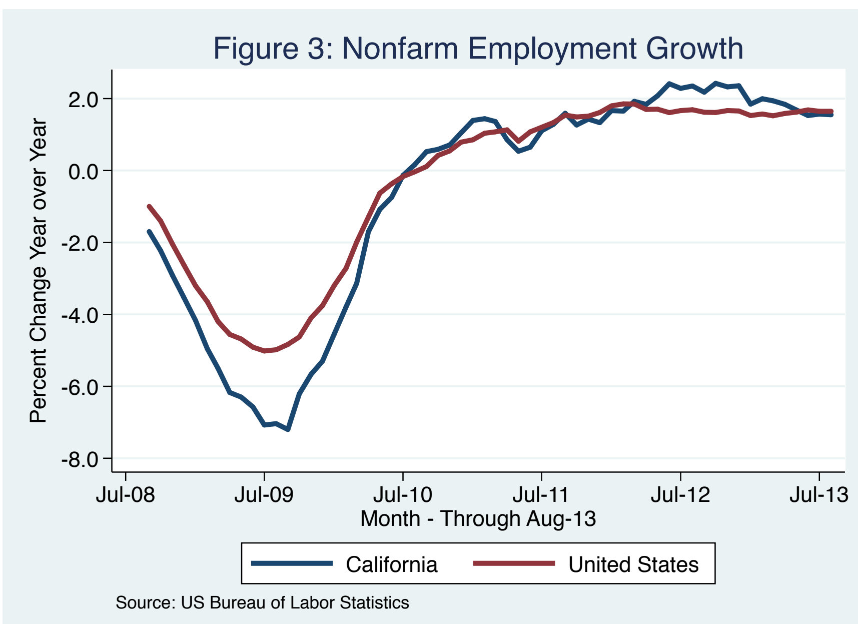
Source: US Bureau of Economic Analysis

The Great Recession hit California harder than most places. This primarily occurred because the housing bubble grew bigger in California than in most other states. Given the relatively high prices of homes in much of California, the demand for high-risk—sub-prime—borrowing became significant here. The availability of these loans drove up demand, as did the appetite for high risk lending, which pushed home prices to historically extreme highs. When the bubble burst, home prices fell more in California than in most of the rest of the nation. The abrupt decline in housing transactions and construction activity caused significant unemployment and dramatically slowed economic activity. That home prices fell by more than half also put a clamp on personal consumption spending (Figure 2).



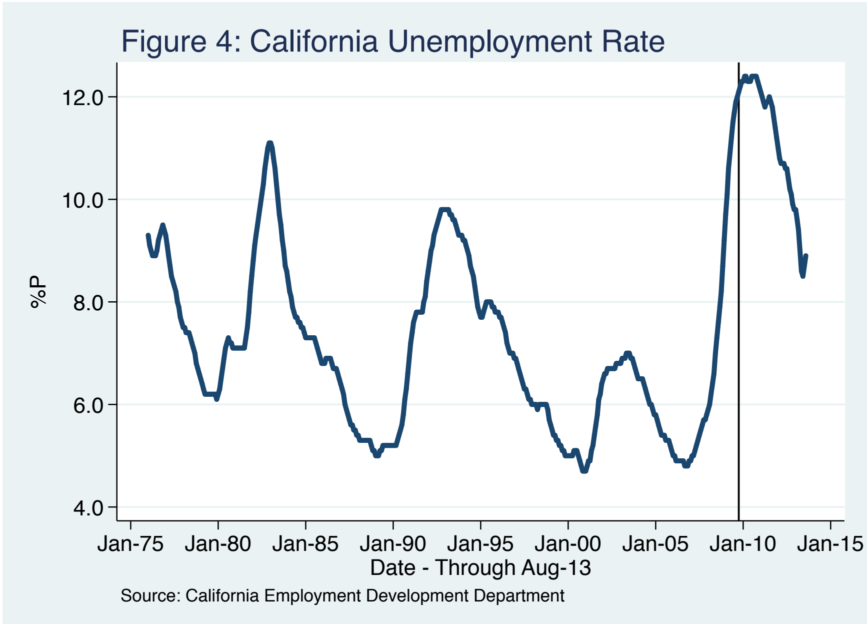
California Returns

In 2012, economic growth in California exceeded that of the rest of the nation for the first time since 2006. California is back. For much of 2012 and into 2013, employment growth also outpaced that in the rest of the country. Accordingly, the unemployment rate dropped at a faster rate than nationally (Figure 3).



By July of 2013, California's unemployment rate had fallen to 8.7% from a high of just over 12% in 2010 (Figure 4). The decline over the last 12 months of

1.5 percentage points is significantly faster than the national decline of just 0.8 percentage points over the same time period. This accompanies real growth of more than 3% in California's Gross State Product (GSP).



While Bay Area counties have generally led employment growth recovery, this is changing as recovery catches up statewide. Employment in the Bay Area grew by 1.7% during the last 12 months while growing 1.5% in California as a whole.

Regionally, the recession hit harder in places with larger housing bubbles. The Inland Empire, Central Valley, and East Bay were particularly hard hit. While statewide employment remains some 3.7% below its pre-recession peak, employment in these three regions is more than 6 percentage points below their pre-recession peaks (Table 1). Employment in much of the Bay Area has recovered more fully, with employment in the San Jose MSA having fully recovered.

Table 1: Total Non-Farm Employment (Thousands)

Area/County	July 2013	Change, Peak to Current (%)
Inland Empire	1,158	-9.4
Oakland (MD)	989	-6.0
Orange County (MD)	1,430	-6.3
Los Angeles (MD)	3,931	-4.8
CALIFORNIA	14,653	-3.7
San Diego	1,281	-2.5
San Francisco (MD)	1,024	-1.7
San Jose	934	Recovered

Source: CA Employment Development Division

On an industry-by-industry basis, the recovery has been generally better in California not only in terms of numbers of jobs, but in terms of the sectors that are expanding as well. Nationally, the expanding sectors provide primarily low wage jobs. In California, a more significant proportion of the jobs created have been in high-wage sectors such as Professional, Scientific and Technical services. California has not been immune from the employment cuts made by the Federal government (Table 2).

Table 2: Total Non-Farm Employment by Industry

		Relative to Pre-Recession Peak	
Industry	**Change, Dec-09 to Present ('000s)**	**Current Shortfall (%)**	**Total Drop (%)**
Total	807	-3.7	-9.0
Leisure/Hospitality	192	0.0	-11.4
Education/Health	162	0.0	-8.4
Prof/Sci/Tech	147	0.0	-12.8
Admin Support	117	-5.5	-17.1
Retail Trade	62	-7.4	-11.1
Transport/Warehouse	31	-3.3	-9.3
Construction	30	-36.0	-39.1
Finance/Insurance	18	-17.7	-20.5
Real Estate	10	-11.2	-14.5
Manufacturing	9	-27.2	-27.7
Information	9	-17.4	-19.0
State Gov	-1	-3.1	-3.0
Fed Gov	-16	-22.5	-17.3
Local Gov	-69	-8.2	-4.4

Source: CA Employment Development Division

Real Estate is Hot in California

California experienced a massive decline in real estate values following the bursting of the housing bubble. When all was said and done, average prices had fallen by as much as 58% from their peak. Over the course of the last year, significant price gains have been experienced, especially in places that experienced some of the larger bubbles—in particular, Contra Costa, Sacramento, and Solano counties. Not all bubble regions stand out as experiencing price gains. The Inland Empire—San Bernardino and Riverside counties—is experiencing significant, but smaller than average price gains (Table 3).

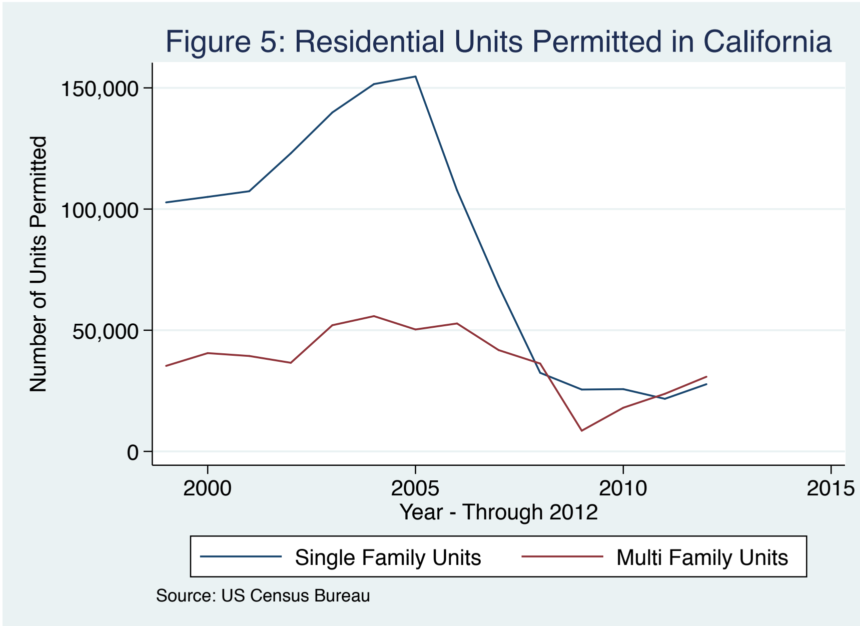
Table 3: All Home Sales and Median Prices by County				
County	**Sales**	**August 2013 ($)**	**August 2012 ($)**	**Year-over-Year Change (%)**
Alameda	1,809	510,500	388,000	31.6
Contra Costa	1,644	420,500	300,000	40.2
Los Angeles	7,991	428,000	340,000	25.9
Marin	358	760,000	644,500	17.9
Napa	134	460,000	350,000	31.4
Orange	3,432	559,000	449,000	24.5
Riverside	3,667	264,750	210,000	26.1
Sacramento	2,165	240,000	175,000	37.1
San Bernardino	2,784	210,000	168,000	25.0
San Diego	4,099	415,000	346,500	19.8
San Francisco	590	820,000	715,000	14.7
San Mateo	740	745,000	629,000	18.4
Santa Clara	1,991	646,955	552,250	17.2
Solano	612	277,500	190,000	46.1
Sonoma	663	401,000	350,000	14.6
Ventura	930	450,000	370,000	21.6
California	42546	361,000	281,000	28.5

Source: DataQuick

Much of the turnaround in real estate markets is a result of historically low mortgage interest rates. Fifteen-year prime mortgage rates had fallen below 3% during the last half of 2012 and through much of 2013. These rates brought many potential buyers into the market.

At the same time, the potential market of buyers is more limited now than it was before the bursting of the housing bubble. The bubble has left many potential buyers with credit ratings that make it hard to qualify for a loan with banks that have significantly tightened lending standards. In California, 57% of potential borrowers have credit ratings deemed subprime, approximately the same fraction of borrowers nationwide. Markets are further complicated by borrowers that are underwater on their homes. Nationwide it is estimated that about 24% of all homes with a mortgage are underwater while the same statistic is 26% for California.

During the bursting of the real estate bubble, construction of new homes, whether single-family or multi-family, fell substantially. Single family residential construction fell particularly dramatically, from a high of over 155,000 new homes permitted in 2005 to a low in 2011 of just 22,000 (Figure 5). A rebound is underway, but construction remains substantially below its peak. Multi-family construction is recovering more quickly, as builders correctly perceive that the demand for such housing will continue to increase, especially as many previous homeowners can no longer qualify to purchase a new home.



International Trade…Is Not?

California views itself as being an international state, with a great deal of international trade and more general interactions with countries and the citizens of Asia. Without question, an enormous amount of U.S. imports pass through California's ports. As much as 40 percent of U.S. containerized imports come through the Ports of Los Angeles and Long Beach alone—with only a small portion of that destined for California firms or consumers.

Historically, California has also been the nation's largest source of exports. This changed some 10 years ago when Texas took over the mantle of the nation's largest exporting state. California remains number two, but its exports are growing more slowly than those from the rest of the country. In only two of the last 10 years did California's export performance exceed that of the rest of the country – and in one of those years, 2009, exports simply fell less quickly (Figure 6).

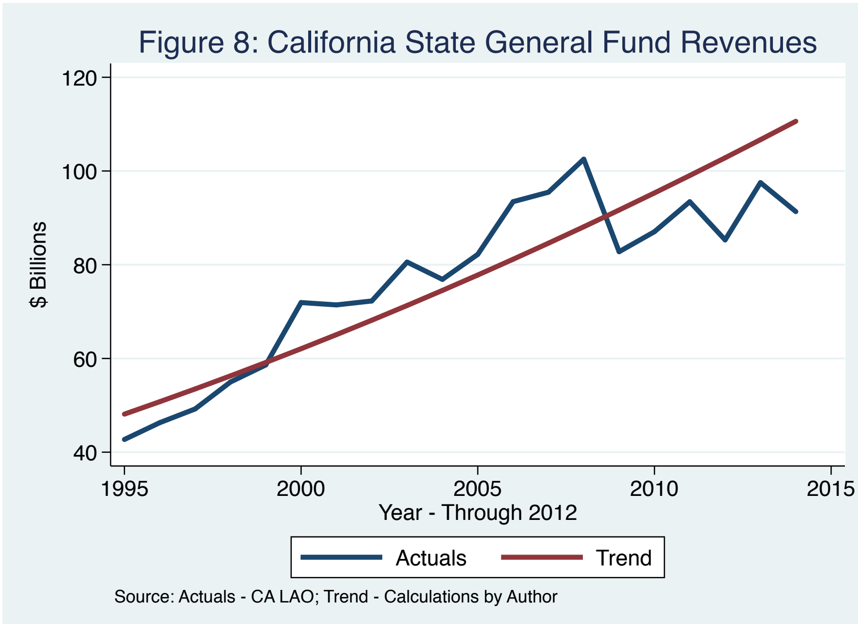
For many years, California's top trading partners were Mexico and Canada. This remains true today as these countries accounted for 27% of California's exports in 2012. For many years, Japan was California's third largest export market. This changed in 2010 as China overtook Japan as the state's third largest export market.

In 2012, California's exports were dominated by Computer and Electronic Equipment. These exports accounted for 28% of all goods and products exported from California in that year. This share of exports, however, is down from a peak of just over 50% of California's total exports in 2000, just before the 2001-02 recession. This share has fallen steadily over the years with a particularly large drop during the recession, from which the industry has not recovered.

California's share of these exports nationally has also been in decline—from 48% in 2000 to just 18% in 2012 (Figure 7). This change reflects a maturing of the industry, which involves the movement of many production facilities outside of California. This trend occurs in many industries as firms with relatively routinized manufacturing processes search out locations with lower labor and land costs and perhaps with fewer regulations.

California State Budget

The California state budget has been a source of great concern and controversy through the Great Recession. Most sources of state revenue contracted significantly and precipitously between 2008 and 2009 (Figure 8). Though revenues have been increasing, they remain well below long-term trends, trends that do not include the significant run-up in revenues in the late 90s or during the housing bubble of the last decade[1].

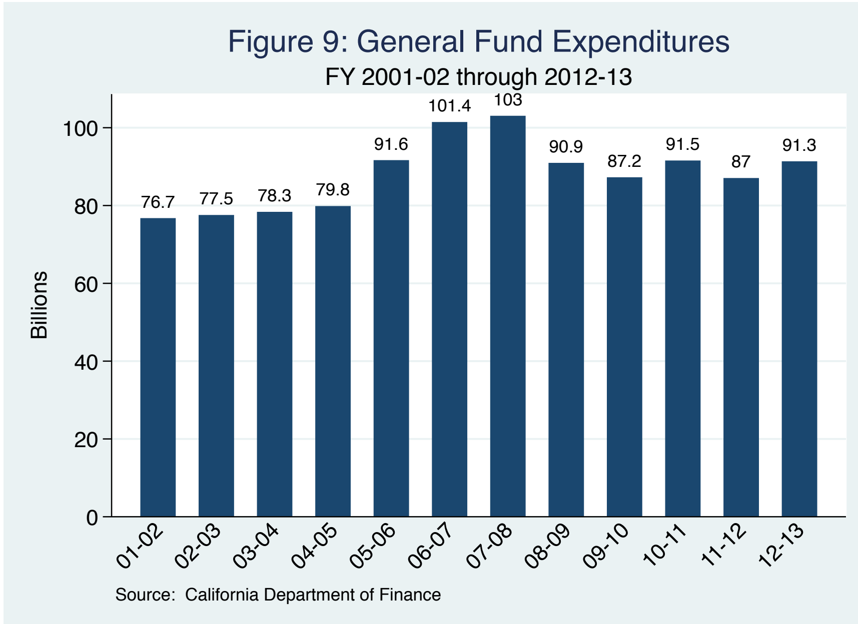


As a consequence, General Fund expenditures were cut significantly. Between the 2007-08 and 2008-09 budget years, expenditures fell by just over $12 billion, from $103 billion to $91 billion. By 2011-12, expenditures had fallen by just over 15% to $87 billion (Figure 9).

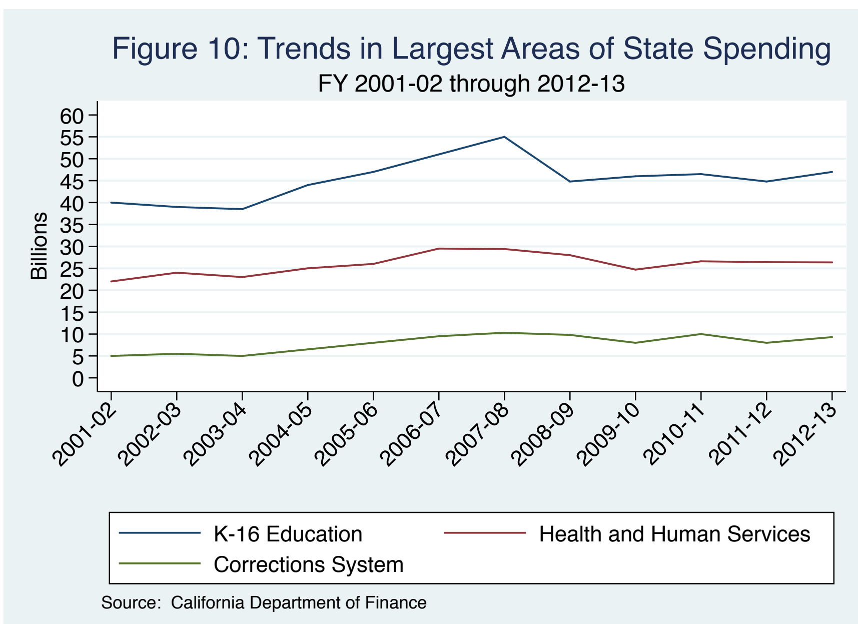
Accounting for 81% of General Fund appropriations, K-12 Education, Health and Human Services, and Higher Education absorbed the brunt of these cuts. K-16 education took a major hit, with expenditures falling nearly $10 billion from roughly $55 billion in 2007-08 to just $45 billion in 2008-09 (Figure 10).

These cuts to education spending are highly disconcerting. The California economy has long been exceptional in part because of its high quality education system, particularly at the university level. The education cuts are touching vitally on one of the state's major assets and may well impede economic growth over the long term.

[1] Based on a regression of state revenues between 1951 and 1995 on a time trend and time trend squared.



The state has also failed to address major issues of concern. These issues include the volatility of major sources of income and the public employee pension issue that plagues the state government as well as many of the state's local governments.



Ever since the passage of Proposition 13, with its limitations on property tax revenue, the state has been highly dependent on capital gains, personal income, and corporate taxes for its revenues. These sources are more susceptible to a downturn in the economy than are property taxes, making the impact of a recession all the more acute given the contractionary effect that it has on government spending. Going forward, the public pension issue is likely to compete with other categories of spending, further reducing the state's ability to deal with its many pressing issues.

California in 2014

Overall, California has been recovering well from the Great Recession. Although employment growth in the state is becoming somewhat more average than it has appeared during much of the recovery, it is expected that solid growth will continue into 2014. There are certainly threats to this continued recovery, should interest rates rise rapidly—due to perhaps a default on U.S. government debt—the recovery in many parts of the state that is driven by construction could falter. This, however, seems unlikely. Interest rates, in particular for mortgages, may continue to rise, but not likely to levels that will derail the recovery.

Sectors that have lead the recovery—in particular professional services and more recently construction—are likely to continue to grow. Housing markets are now recovering well, perhaps too well as a result of low interest rates, but a downturn in this sector is unlikely in the near future.

Overall, California is well positioned to achieve solid growth in 2014. Highly productive, well paying industries are growing here more than elsewhere. These sectors have long been the strong suit of the Golden State, and there is no reason why in the short term, the future won't bring more of the same. At the same time, the California economy remains fragile and is subject to some of the same threats that the overall U.S. economy is facing. Furthermore, over the long term, there are internal stressors on the economy that may well reduce the state's long term potential.