



Living On a Fault Line

Like millions of other Californians, I live a stone's throw from a major earthquake fault. The Hayward Fault, a branch of the gigantic San Andreas Fault, runs through a golf course adjacent to my house. It's not that I intentionally chose to live on or near a fault line; I chose to live in California and the state happens to be crisscrossed by a network of earthquake faults. Sure, I worry about the Big One, but only when watching those scary disaster films.

Nonetheless, the sight of devastation after Hurricanes Katrina and Rita was a powerful reminder that natural disasters can seriously disrupt not only our personal lives, but our economy as well. With hurricanes, we will have some forewarning. But earthquakes, a type of disaster to which California is particularly susceptible, strike without warning.

According to a recent *BusinessWeek* story¹, a magnitude-7 quake in Los Angeles could cause the loss of many lives and property damage up to \$250 billion. This sum is possibly greater than the damage from Hurricane Katrina, currently estimated to be around \$200 billion. If a similar-sized earthquake strikes the San Francisco Bay Area, resultant damage could be at least tens of billions of dollars. As horrific as either of these events might be for California, the impact on the national economy would likely be limited, just as the impact of both Hurricanes Katrina and Rita is projected to be.

Hurricanes' impact on the national economy is limited.

The reasons for a surprisingly mild and brief impact that major disasters, such as hurricanes, earthquakes, and terrorist attacks, might have on the national economy are threefold. The first and primary reason is the overall size of the U.S. economy, which is roughly \$12 trillion dollars in total output. Our economy is so huge that even a major catastrophe could hardly influence national statistics.

The second reason is that, in most cases, economic activities within an affected area might simply be interrupted or temporarily postponed. When consumers can finally get to stores, they often purchase what they were planning to buy earlier. Also, when relative normalcy returns to the area, business activities tend to resume quickly.

The third reason is that disasters themselves can generate economic activities. In the short run, people make emergency purchases, from flashlights to hotel rooms (for temporary evacuations), that they might not make under normal circumstances. Over a longer period, clean-up and

reconstruction efforts do create a large number of jobs. Some reconstruction projects, such as rebuilding of highways and bridges, could continue for years. These disaster-induced activities at least partially offset those that have been interrupted or aborted.

Long-term outcome depends upon government responses.

There is no denying that some industries and jobs might permanently move out of the area and never return. If an area's key industry relocates, that would be economically devastating. However, this should not be a foregone conclusion. How the area will fare ultimately depends on multiple factors.

In fact, it is possible for a major disaster to make the affected region more productive than before. Here are a few reasons why that might be possible. First, disasters often "flush out" less efficient businesses because their lower profitability cannot justify additional investment needed to reopen. Second, a further boost to productivity comes from the purchase of new equipment embodying the latest technology. No one replaces a five-year old computer with another soon-to-be obsolete computer.

Third, if — and this is a big supposition — if a sensible mix of planning, regulations, and incentives is put in place by local and federal governments, more efficient industries with better paying jobs could establish themselves and might take the place of those that have disappeared, bringing renewed economic vigor to the affected area.

Relief efforts will extend the economic expansion.

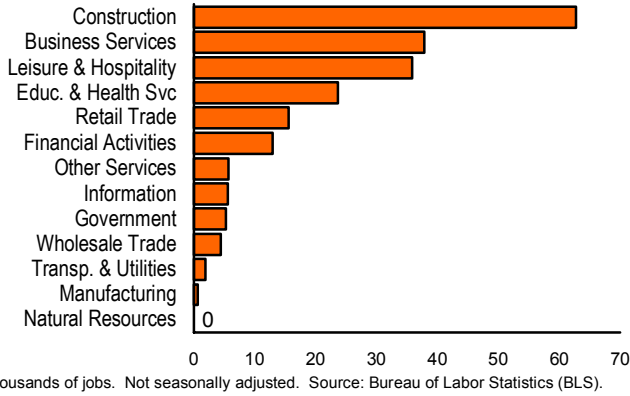
My current estimate for necessary federal government expenditures to rebuild the Gulf Coast region is about \$140 billion. Mind you, this is a very rough estimate based on preliminary information. While Congress has already authorized \$62.3 billion in emergency spending to take care of immediate needs, at least \$50 billion more is likely to be needed for reconstruction of the region's infrastructure.

In the days prior to Katrina, some forecasters predicted a moderate slowdown of the U.S. economy in the second half of 2006. With a large sum of federal funds to be unleashed into the economy over the next twelve months, the current economic expansion is likely to continue well into 2007.

This necessary but unanticipated rush of fiscal stimulus will heighten the risk of an overheated economy, and, coupled with today's higher energy costs, increase inflation worries. Expect the Federal Reserve to counteract the expansionary fiscal policy with continued rate hikes.

¹ *BusinessWeek*, "The Next Big One," September 19, 2005.

California Job Growth Aug. 2004 – 05



California’s housing market will likely be affected.

With almost 2,000 miles separating California from the Gulf Coast, the state has been shielded from the immediate impact of Hurricanes Katrina and Rita. That, however, is likely to change in coming months.

The demand for, and resulting costs of, building materials, from concrete to plywood, will inevitably rise nationally as the reconstruction of New Orleans and the surrounding area begins in earnest and as resources and supplies are channeled away from other markets. That will directly affect homebuilders’ bottom line.

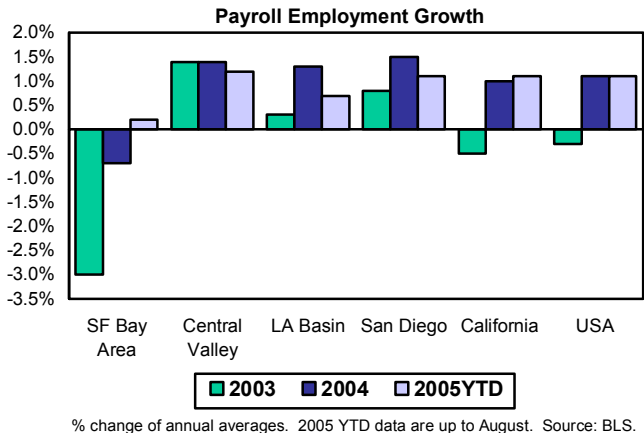
If prices of new homes must be raised to compensate for increased material costs, that is likely to worsen housing affordability problems in California. We cannot also ignore the possibility that continued tightening by the Fed finally starts to exert upward pressure on mortgage rates.

As seen in the preceding chart, the building industry has been the largest generator of payroll employment in California over

the past year. While the elevated cost of new homes alone may not end the housing boom, the importance of the construction sector related to job creation may diminish.

Employment growth continues in California.

During the first eight months of 2005, California added 163,300 jobs on a seasonally adjusted basis. Year-to-date job growth in 2005 has been about par with the national average. (See the chart below.) Employment growth has been robust in the Central Valley and San Diego. Even the San Francisco Bay Area has started to gain jobs.



The service sector is leading employment growth in California, while the housing sector (construction and financial services) still contributes positively. So the continued expansion of the Golden State economy seems to be assured over the next few quarters — unless, of course, the Big One hits...

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Economic Forecast – October 2005

UNITED STATES	2003	2004	2005	2006
Real GDP Growth (%)	2.7	4.2	3.6	3.7
Unemployment Rate (%)	6.0	5.5	5.1	4.9
Consumer Prices Change (%)	2.3	2.7	3.2	2.5
Federal Funds Rate (%)	1.1	1.3	3.2	4.5
CALIFORNIA				
Real GSP Growth (%)	3.4	5.1	4.0	3.8
Nonfarm Employment Growth (%)	-0.5	1.0	1.6	1.9
Personal Income Growth (%)	3.1	6.1	6.7	5.9

Bold: Actual. GSP stands for Gross State Product.

The information in this report is based on data available as of September 28, 2005, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied on as a sole source of information and opinion.