

California Slowing: A Lull or a Downturn?

Talk of a national recession is getting louder.

Pessimism about the nation's economy is on the rise. Analysts are now frequently mentioning the possibility of a recession in the United States in 2008 and the need for the Fed to prop up the economy with additional rate cuts.

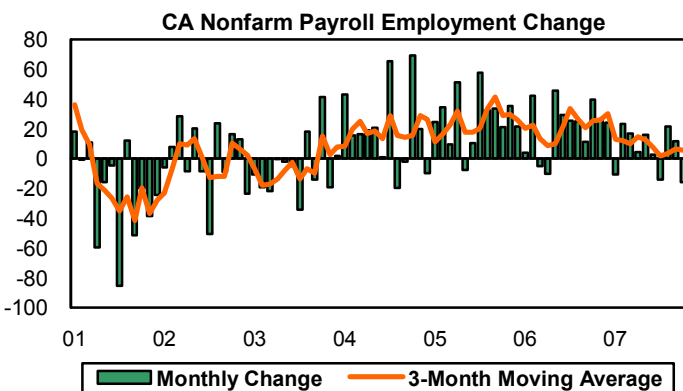
In the meantime, macroeconomic indicators by and large tell us that the economy still has good momentum. The Gross Domestic Product (GDP) jumped 4.9% in the third quarter on an annualized basis, the strongest expansion since 2003. The economy keeps adding jobs month after month, with the most recent gain of 94,000 in November. These numbers do not suggest that the nation is on the brink of a recession.

Still, all this talk of a possible national recession heightens interest in the outlook for the California economy. As we approach the New Year, many Californians are wondering about the probability of an economic downturn in their state.

State-level recessions are hard to define.

Discussions of recessions in individual states, however, are tricky, because there are no widely accepted definitions of state-level recessions. The National Bureau of Economic Research (NBER), a private, nonprofit research organization, is the official arbiter of matters related to U.S. business cycles, but NBER does not specify the dates that recessions begin and end among individual states.

A popular definition of a recession is two consecutive quarters of declining real GDP. This is not a true definition of a recession, but it is nonetheless a quick and easy way to determine whether the economy is experiencing a broad decline in aggregate activities. Unfortunately, the Bureau of Economic Analysis releases the state-level GDP only once a year, so this definition of convenience does not work for states either.



In thousands. Seasonally adjusted data. Source: Bureau of Labor Statistics (BLS).

Perhaps the most reliable indicator of a recession in a state is employment data. The preceding chart of monthly

employment changes clearly shows that California was in a recession in 2001, with significant job losses.

Growth slowed in California in 2007.

The same chart also shows that growth has decelerated over the past year. At October 2006, the three-month average for job growth was 25,600; a year later in October 2007, the average was down to 6,100.

Much of the recent slowdown can be attributed to the soft housing market. Between October 2006 and October 2007, the construction sector lost 31,200 jobs. (See the chart below.)



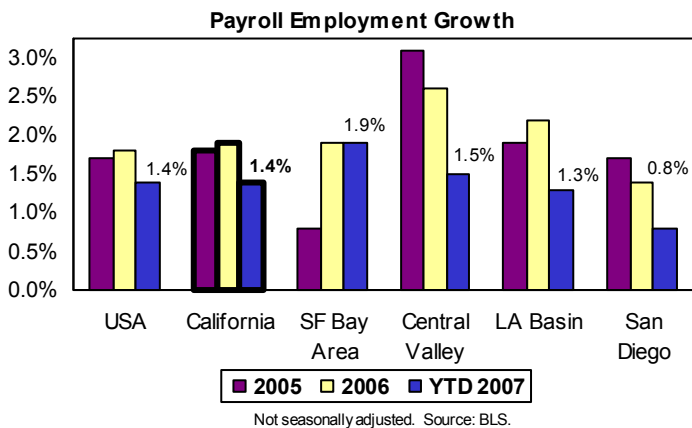
The building industry was the most important job growth engine in California between 2003 and 2006, expanding about 5% year-over-year on average. The industry, however, turned into a drag on the economy in 2007, with the number of workers shrinking rapidly. In October, the construction sector employed 3.3% less workforce than a year earlier.

Another big "loser" was the financial sector with a loss of 12,900 jobs over the same period. Most of these financial job losses occurred in mortgage lending, so the housing slowdown cost California about 44,000 jobs over the past year.

On the other hand, robust job growth has continued in the service sector. Educational and health services lead the pack with an addition of 51,000 jobs since October 2006. Leisure and hospitality services are performing well because of a domestic tourism boom. The recovery of the information-technology sector has created many professional and business service positions.

The government sector has also been enjoying healthy growth lately. The public sector tends to lag the private sector in employment cycles. The current surge in government

employment is a reflection of strong economic growth over the past few years in California.



On an annual basis, California has lately had a similar experience as the rest of the nation. As of October, the year-to-date payroll employment growth in California was 1.4%, compared with the same 10-month period in 2006; this rate was identical with the national average. (See the chart above.) Job growth in most regions within the state has slowed since 2006. The only exception is the San Francisco Bay Area. The aforementioned tech-sector recovery has buoyed the region.

A temporary “lull” or a serious “downturn”?

Does this mean that California is headed for a recession? Or that the state’s economy is simply taking a breather? The probability of a recession in California in 2008 (with clear signs of employment decline) will depend on a delicate balance of positive and negative factors.

On the negative side, the weakness of the housing-related sectors, such as finance and construction, is expected to persist in 2008. With the current turmoil in the mortgage market, it will be a while before the housing market finds its footing. Offsetting this weakness are the service and

government sectors, though public-sector employment growth may already have run its course.

Additional positive factors are health care and tech-related professional services, which will likely continue adding more jobs. The tourism boom could lose some of its luster because of high prices of gasoline and airline tickets, but the falling dollar and the synchronized global economic expansion may bring more foreign tourists to California.

Positive trends in the global economy will also help the state’s manufacturing and agricultural sectors, both of which are extremely export-oriented. Business activities of the state’s technology and entertainment industries are global in scope, and both industries are poised to benefit as well.

Some people were worried about the impact of October’s Southern California wild fires on the economy. The damage was extensive and it was a devastating event for those who were personally affected. However, given the size of the state economy, we will be hard pressed to find any discernable impact of the fires in the overall economic data.

More worrisome, in my opinion, is the television and film writers’ strike. Its impact will be felt more clearly in 2008 as film and TV production comes to an eventual halt—that is, if the strike does not end soon. Further, the contracts of the Screen Actors Guild and Directors Guild of America are set to expire in July 2008. If their contract negotiations do not turn out well, that could spell even bigger trouble for Hollywood.

While I am personally quite optimistic about the California economy, it is too early to tell how those positive and negative factors will stack up next year. Will the housing market find a bottom? Will the entertainment industry tip the scale? We all need to stay tuned.

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Economic Forecast – December 2007

UNITED STATES	2005	2006	2007	2008
Real GDP Growth (%)	3.1	2.9	2.3	2.7
Unemployment (%)	5.1	4.6	4.6	4.8
Nonfarm Employment Growth (%)	1.7	1.8	1.3	0.9
CPI Change (%)	3.4	3.2	2.8	2.5
Federal Funds (%)	3.2	5.0	5.1	4.0
CALIFORNIA				
Real GDP Growth (%)	3.8	4.2	2.6	3.1
Nonfarm Employment Growth (%)	1.8	1.9	1.2	0.7
Personal Income Growth (%)	6.5	6.5	6.1	5.6

Bold: Actual.

The information in this report is based on data available as of December 18, 2007, 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.